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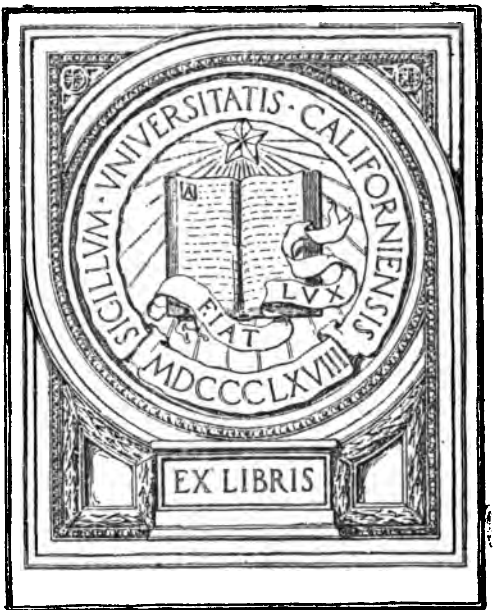

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How to Select Investments

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How to Select Investments

BY

FREDERICK LOWNHAUPT
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PREFACE

THE chapters included in this book were originally published in THE MAGAZINE OF WALL STREET. They are reprinted, with some minor revisions, because of their permanent value to investors.

All the authors here represented are men of standing and experience in the investment field. Frederick Lownhaupt is the author of "Investment Bonds," widely used as a text-book. G. C. Seldon, of the Editorial Staff of THE MAGAZINE OF WALL STREET, is the author of a number of popular financial books. George Garr Henry was formerly Vice-President of the Guaranty Trust Co. of New York. William H. Tibbals, now deceased, was a member of the Salt Lake Stock Exchange and an expert judge of mining securities. John J. Cushing is a New York attorney, formerly Editor of "The Corporation Searchlight."

The varied points of view here presented make the volume more suggestive than if it had been entirely written by a single author.

THE MAGAZINE OF WALL STREET.

New York, July, 1918.

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UNIV. OF CALIFORNIA

CHAPTER I

Bondholders Are Creditors of the Corporations Whose Securities They Own

AMONG the most curious phenomena of the investment business is the woeful ignorance of many bond buyers as to fundamental facts. It is peculiar that people should give their most vital attention and study to some line of business endeavor wherein they accumulate their money and then with the most supine indifference leave the investment of the gathered profits of the grown fortune to the haphazard and hit-or-miss methods or lack of methods that are so evident among the security-buying public.

The indictment holds notwithstanding the fact that there is a strong demand for investment literature and that a certain degree of investment education has been attained by many.

It is not easy to acquire a working knowledge of investments. There is no royal road to this state. Only years of study and practical hand-

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ling of the details make the person engaged in the business of selling bonds familiar with the many fine points along with the general principles of investment. Much less can he who gives no more than desultory attention to this wide and difficult subject expect to gain a degree of proficiency enabling him to form accurate judgments on the securities offered him through extensive advertising and by the persistent bond salesman.

There are certain foundation principles underlying the superstructure of investment buying that must be observed by the conservative banker in buying securities as well as by the individual investor when buying them over from the banker. But generalizations do not carry finality. Beyond a goodly number of generalizations or principles there is a vast amount of specific information that must be injected into the case. That is to say, a certain number of fundamental facts must be ascertained about an investment, after which the investigation or study must proceed with numerous details affecting that particular security.

For that reason the student of investments never reaches the end of the course. New conditions arise with every security presented, each

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time changing the value of various factors so that the situation as applied to one bond of a certain type may be vastly different as applied to another bond of the same type, but coming from another locality. For instance, a bond issued by one steel company may be almost entirely different from that issued by another steel company, and yet both may come under the general heading of industrial securities around which there are a number of fundamental considerations which are seemingly a fair measure of value.

Broader even than these fundamental considerations of particular classes of bonds are some facts upon which every investor should build his financial knowledge, facts that unfortunately are too often forgotten.

The very foundation among these facts is that the investor stands as a creditor of the corporation whose securities he holds. To the investor with a fair amount of financial knowledge the statement seems obvious.

And because the bondholder is only a creditor it is of vital importance to him that safety be his highest consideration. He differs from the stockholder in that the stockholder is a partner in the

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business who draws a larger return in the form of dividends when larger earnings result, and who manages the business altogether without one word of suggestion or advice from the bondholder. Only in rare instances does the bondholder have any voice in the management of the company, and that situation usually arises only out of reorganization proceedings.

The very fact that the bondholder stands practically impotent in the direction of the affairs of his debtor is the reason for the utmost conservatism in the selection of the debtor. There is a curious antithesis between the attitude some very shrewd business people take toward their security investments and the position they assume toward individual debtors. It may be argued that there is a measure of reason in this course, inasmuch as the vicissitudes of business are more easily weathered by a large corporation. But the standard of integrity and financial strength should not be weakened merely because the debtor is big.

It is true that investors usually buy the bonds of a company which, at the time they make their investment, is being administered in a most capable manner. But the fact that these investors

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are powerless to prevent the transfer and shifting of the ownership of the company's stocks adds an element for caution that may well be considered. For this reason there is ground for emphasizing the necessity of a substantial margin of safety for the bonds.

This aspect of the question does not arise in the consideration of a large majority of steam railroad bonds, since there is unity and concentration in that field and rather definite delimitation of spheres of influence. It does apply with greater or lesser force to industrial securities, especially where they represent the smaller and detached enterprises.

We need not go into history for several examples of the fact that the character of the debtor corporation is determined by the character of the management. In other words, the business of a corporation may be good enough, *per se,* but poor management brings inevitable shipwreck, which may leave the bondholders only a shred of value for their securities.

As a creditor holding the paper of a corporation, the bondholder cannot too insistently inquire for the record of management, which is reflected in numerous ways, not alone in the suc-

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cess of the enterprise in increasing its gross business, but in the method by which it conducts its accounts, in the way that it has provided financial requirements in the process of growth and in the way that the property and plants of the concern have been cared for.

The bondholder is recreant to his own interests if he neglects to weigh each of these considerations before accepting the bond.

In brief, the creditor should feel assured that the proprietors, the stockholders represented through their board of directors, furnish ample evidence of the security of the debt, not only through tangible and physical pledge of property wherever that be possible, but through operation of a conservative business policy and administration.—Frederick Lownhaupt.

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CHAPTER II

A Bond Represents a Small Piece of a Larger Debt

THE average investor falls far short of giving the proper attention to the investment of his surplus. It would be too much to ask that he be strictly scientific in the distribution of his funds among securities. That is acquired only after years of laborious study and investigation and perhaps after a broad experience in the handling of investments.

Anyone having large amounts of funds to handle would be expected to have a working familiarity with the principles of investment. There is, however, no more reason why he should understand fully what he is doing than the investor with a small amount of money. In fact, the smaller the amount available for investment the greater the necessity for its wise placement. The man with a thousand dollars can far less afford to lose anything of his principal than the man that can buy fifty of a hundred or more bonds.

In a previous article emphasis was laid upon the fact that the bondholder is a creditor. In this

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article it is sought to lay the emphasis upon the fact that his position when holding a very few bonds is comparatively insignificant, although he does have certain rights which are, however, only enforceable insofar as many bondholders move together.

If the average bond buyer fully realized that he holds only a small part of a larger debt, and in some cases a very big debt, he would be stimulated to a better consideration of a number of things than he gives now.

It is peculiar to note the great care that many people exercise in the selection of real estate investments. That is to say, they purchase these only after a thorough investigation of the position of their mortgage on the property, and in no case would consider the investment were the debt so large as to appear excessive and overburdensome for the property. Yet they, if they are bond buyers at all, and others who are regular purchasers of bonds will take up this form of security with few questions or none about the relative size of the issue of which their bond is a part.

This is not to say that the same application of the principles of investment can be made to real

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estate mortgages as to railroad bonds secured by a mortgage on an important steam railroad, as there are peculiar considerations in real estate that do not hold in the other case, but it is to say that too little attention is often paid to the relative position that an issue holds to the mass of securities on various properties.

A very big issue of bonds generally takes its place in the scheme of things following a number of other bonds that have been out for a long time. Now if this latter debt is so big that the company is going to have a hard time meeting the interest on it when business conditions are not good, it is a matter of vital interest to the bondholder. Such situations have arisen, and, of course, more are to come. In other words, the company that has a large bonded debt generally has a number of small issues followed by a very large one. And this large issue may be the last one brought out. That is, there may be a substantial number of issues that have precedence to it. With all these ahead of it, its very size, or, rather, the great amount of interest that it will require, may make it a vulnerable point in a business depression and serious falling off in earnings.

It is, of course, possible to say that many of

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our railroads can support a large debt and can capitalize their improvements and expansion constantly in the form of bonds, but the bigger the debt becomes the more the investor should remember that there is a vast amount of debt beside his bond on which interest must be paid and that only so far as all this is met right along can the company keep out of trouble.

Let a company fail to pay any of its fixed bond interest, and within a comparatively short time, perhaps not more than thirty days, it may be in the hands of receivers and in a position where all those holding its debt may be kept out of their interest indefinitely, and some almost certain to lose at least all the interest due them and a part of their principal.

The investor should study these questions carefully rather than throw money into a security which, just because it is called a bond, might be thought by others to be a thoroughly safe investment.—FREDERICK LOWNHAUPT.

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CHAPTER III

The Investor Should Diversify His Holdings

ONE of the cardinal principles of scientific investment makes it imperative that the bond buyer diversify his holdings in two ways at least. One of these lies in the direction of the type of security that he selects and the other has particular reference to the geographical location of the properties.

Mr. Carnegie once said, "put your eggs into one basket and watch the basket," a maxim which may have held good in the particular case under consideration, but which is not applicable to the general question of investment. A striking example of the wisdom of this saying, as applied to industrial operations, was furnished some five years ago when one of our largest industrial corporations fell into receivership simply because its early strength was not conserved and concentrated, but was dissipated over a wide international territory.

The diversification of investments may not seem important to the man of narrow means, say

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one who can buy only five bonds, yet here is the very one who should give the subject the most critical attention. The man of five thousand or even five hundred dollars should certainly divide his modest fortune into five parts and make a selection, or at least have a selection made for him if he is unable to do it himself, of such investments as will give him a substantial return with the greatest degree of safety.

The wisdom of distributing one's funds over a variety of securities is so obvious to the trained man in investment affairs that it is practically an axiom. It is one of the first rules of a banking house seeking to hold its clientele and to build up an organization that will become increasingly stable.

The emphasis which such a house lays upon the principle of diversification may be construed, if the reader so chooses, as enlightened selfishness. Many opportunities arise for the bond house to give a customer a solid block of one kind sufficient to absorb all his funds, but yet the house always has a greater interest in spreading its sales over several issues. In this way it insures to a marked degree the continuance of patronage and a better satisfied customer.

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The insurance is against the possible serious harm that might come to the investor were he committed entirely to one issue. There is no guaranty that a house, however careful it be, can sort out with unerring accuracy propositions that will never fall into unfortunate straits. Some of the best houses have almost perfect records, but not quite. That is to say the percentage of their successful selection is very high, yet notwithstanding this fact they cannot afford to have tied up an investor in just the one or two issues that prove unsound. The writer has in mind a house that has an enviable record, but withal had, at least a few months ago, a rather substantial group of disgruntled clients which took heavy blocks of a certain security. It is obvious that the house must avoid this state of affairs and must therefore emphasize to an unusual degree the principle of diversification of purchases. Another excellent house of very high standing literally harps upon the point of the advantageous spreading of investments. Yet with all its cautiousness it has not a perfect record.

If then the banking house, which has at its command and which brings into play all the extensive machinery for sifting and analyzing the

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investment before it is offered to the public, cannot be sure of a perfect score over a period of a few years, much less can the individual expect to avoid all mistakes. Appreciating this fact most keenly, the banking houses advise their clients against too great concentration.

The arguments against concentrated investments for the average bond buyer are definite and conclusive. It is true that there are certain bonds whereof the investor may purchase freely and in fact hold in large part. There are numerous old, seasoned and established railroad issues that are legal for the savings banks of New York state, which may be purchased with impunity and in large amounts. But the drawbacks to this character of buying is that it nets pretty nearly the lowest amount of income. From the standpoint of safety there could be little objection, but from the broader viewpoint of a well balanced investment there is the obvious fact that something must be sacrificed in the way of income.

The argument might, however, be extended to the point that any one railroad property is subject to vicissitudes in greater or lesser degree, and that reasons might be advanced for not confining the investments to this one property. Es-

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pecially does this apply if the railroad is not one of the highest credit and established position as regards business. It would be thoroughly unwise to concentrate one's funds in a semi-investment railroad issue, that is to say, an issue that yields around 5½ per cent. under normal conditions, and one whose margin of safety fluctuates with changing railroad earnings. To concentrate on this one kind of security would be unsound enough, but to make any one issue the vehicle of such an investment would be doubly unwise.

The element of income, of course, is the attractive feature about such bonds, but the degrees of safety vary to such an extent that the average investor cannot afford to pursue such a course in the placing of his funds. Suppose, for instance, that Wabash-Pittsburg Terminal bonds had been the sole medium of investment. What would have been the result is fully known. At the time these issues were brought out there were ample reasons to consider them securities of high class and large promise and such as would have an increasing factor of safety for protection. What actually happened is too well known for repetition. The example affords a forcible text for

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just such an admonition as this article seeks to give.

There is another aspect of the matter that demands consideration. Medium-grade railroad issues, that is, securities of the type usually recognized as "business men's" bonds, are far more subject to fluctuations in price than the high-grade bonds. If therefore an investor were committed entirely to one issue of this character or to a number of such issues and there came along a time of serious depression in prices his bonds might fall off five or more points from the purchase price. Possibly at that moment there might be reasons for converting the securities into cash. A sale might mean a considerable loss on the principal. It stands out clearly that he would get marketability in these bonds and would have been enjoying a substantial income, but he would have had to sacrifice in an open market sale an amount of principal that might more than offset all the advantage gained in income.

Now if industrial bonds made up the entire investment, how would he fare? Quite as much emphasis as was laid upon the undesirability of taking up altogether second grade railroad issues might be laid upon the statement that no one

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should let industrial issues bulk too large in the make-up of a portfolio. Undoubtedly there are a substantial number of such bonds that are removed some distance from harm's way even in the worst storm, yet under certain conditions more or less anxiety would be justified.

It does not take a long depression to eat into the earnings of some industrials to an alarming extent. The general conduct of the business and upkeep of the plants must be highly conservative in good times to make provision for the lean years. Assuming, however, that the danger point were well provided against, the very fact that earnings were going down and business becoming poorer would be reflected in market quotations, and the investor would be confronted with the same situation as in the medium-grade railroad issues when the question of marketability arose. Here as in the other case he could liquidate his investment only at declining prices.

What shall be said as to his position were he holding public utility bonds altogether? Because of the fact that public service corporations as a class have won their distinction in respect to stability of earnings, the investor might have little to fear in many cases from this point of view. It

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would be nearly universal if the bonds were not affected at all by general conditions, but it may be taken for granted, basing the assumption on the record, that the price declines among the best issues would be comparatively slight. Public utility corporations are not immune to difficulties, but it must be said for them that once well established they succeed admirably. Granted that the margin of safety in earnings is good for an average number of years, it is safe to believe that a flurry of conditions which might make considerable inroads upon the earnings of some of our railroads and upon many of our industrial companies would not seriously affect the position of utility obligations.

The matter of market might prove a stumbling block, however, if the bonds were of an issue that could not be taken care of in some way by interested banking houses. The advantage of a wide, open market would not be enjoyed by many issues. But this is less a drawback than the loss of principal or weakened security. As a matter of fact a very large bulk of these utility bonds go to investors who have no intention of liquidating, or who are not every now and then under the necessity of selling their holdings.

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This whole matter of diversifying investments may be summed up in a few words. Enough reasons have been brought forward to show the wisdom of such action. Such procedure is one long step on the road to scientific investment.

The thoughtful investor takes into consideration four aspects of the subject. He gives due regard to the safety of his money and therefore invests so that his investment may not be impaired at one fell swoop by what may happen to a single company or class of organization; he takes into account the fact that he cannot sell all bonds with equal facility; he considers the fact that certain conditions work with varying effects on different corporations and their securities. Therefore he has to discriminate wisely in the matters of income, marketability, safety, types of bonds and location of the properties.—FREDERICK LOWNHAUPT.

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CHAPTER IV

As a General Rule the Risk in a Security Increases with the Income

HOWEVER often this statement may have been made, it needs to be made a great many times more. If there is anything that investors know absolutely and quite as thoroughly forget, it is this very fact. Unconsciously thousands of investors have been carried with the tide of modern tendencies, so that they find themselves rather distant from where they were some years ago. That is to say, ten or fifteen years ago a much larger proportion of investors adhered to the idea of least risk and accepted without question 4 per cent. or very close to it.

Some years ago the apparent acme of safety was in a security yielding around 3 per cent. Some of the high-grade railroad bonds exemplified this character of investment. As a matter of fact, however, the investor who was looking for the irreducible minimum of safety in those times could have taken his choice of a number of municipal issues that carried him even below 3 per cent., notably those of the City of New York,

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which were selling around a 2.90 per cent. basis, or United States Government bonds yielding even less than 2 per cent. Of course it has been recognized for a long time that our government bonds issued before the war are not investment securities in the generally accepted sense of that term.

The range of income in those times was very wide, giving as a consequence a much broader latitude within which to work in selecting a group of securities.

There is only a slight difference in the degree of risk involved in investments yielding 4 per cent. and those yielding 4¼ per cent. It would be a rather presumptuous investment adviser who would undertake to define clearly the exact difference in degree of risk in two bonds of a difference of one-quarter of one per cent. at that point. Add another quarter of one per cent. to the income and the difference is still comparatively unimportant. The distinctions in point of safety between bonds of these income bases are not always readily apparent even to the trained man.

Raising the income to 5 per cent. we still are within the bounds of safety, but, of course, we

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cannot, under ordinary peace conditions, claim for such a security the high degree of safety that holds in the case of the 4 per cent. bond. There was a time not long ago when the 5 per cent. bond was classed as a business man's investment, meaning that the degree of risk was about what the average business man could well afford to take, but now many 5 per cent. bonds are better than an average business man's risk. In fact the burden of some of the best advice is to the effect that the 5 per cent. bond has come to stay, even after the war, and that conservative investors may ask 5 per cent. on the average on their holdings and rest easily.

There are so many qualifications in the stating of the degree of safety or risk that goes with any bond that it is impossible to generalize. There are public service securities that for all that may be discerned or judged by all the bankers are thoroughly sound and will never rest under the shadow of doubt as to the ability of the company to earn its full fixed charges in all times. There are others of the same class yielding around the same amount of income which are perfectly good, but about which there cannot

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be thrown the same air of security as in the former case.

The question of the degree of safety existing in two bonds may be roughly illustrated by citing the underlying issue of, say, a good railroad as compared with a junior issue of the same company. Assume that the margin of earnings is far and away sufficient to take care of the interest on the junior bonds with a wide distance to spare. How shall be declared the difference in security of the two bonds, except it be purely theoretical? The difference in market price must be built upon the difference taken to exist in the quality of the liens.

Once the investor gets above 5 per cent. he moves into a compass within which the elements of security change more or less rapidly and noticeably. For instance, the difference in security between a bond yielding around 5 per cent. and another yielding around 6 per cent. is as a rule quite marked. Certain factors begin to show themselves plainly when the security goes toward 6 per cent.—fluctuating earnings, or a speculative type of business, a narrow margin of earnings available for the particular bond, or some other

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consideration that works with equal force on the market position of the bonds.

Beyond 6 per cent., of course, these factors become accentuated and there are generally market fluctuations of a most pronounced character. There are a number of corporation bond issues on the Stock Exchange yielding around 6½ per cent. and even up to 7 per cent. and over, that are almost as speculative as many common stocks. The earnings upon which they depend fluctuate widely so that in the periods of poor business the question comes up naturally as to whether the danger point is near.

It is in this class of bonds that the speculator in bonds finds his great opportunity for large profits. His income alone is big, but he may even augment this by operating in the bonds and catching fluctuations in price. The trader of this type enjoys at least this satisfaction and assurance—that interest on his bonds will be paid till the last vestige of expediency has vanished, whereas in the case of the average common stock dividends may be reduced or even passed when only ordinary prudence dictates such a course.

A common method of getting substantial income and still the largest degree of safety com-

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mensurate with such return is to distribute one's investments over a group of bonds beginning with the low interest, high security type and going through the various degrees of safety and income so that the average income is well up toward or is at 5 per cent. In this way a large part of the principal is secured beyond a peradventure and only a small part is exposed to the dangers of decline and default.

For the investor who has the time or the inclination to keep in touch with the market such a combination offers opportunity for good profits. Furthermore, in this method, if the bonds are all carefully selected, there is likely to be less risk than in a group of bonds all yielding exactly the desired average, as the total investment will probably cover a wider field and thus afford a greater distribution of risk.

After this fashion some very scientific investing can be done so that an investor may venture over into the area of carefully selected speculative securities, always keeping a preponderating weight of highly conservative and semi-investment issues to over-balance whatever risk is involved in the speculative holdings.—FREDERICK LOWNHAUPT.

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CHAPTER V

The Ultimate Safety of a Bond is in Ample Earnings

THERE are two great factors in the selling arguments built up around every bond or preferred stock issue. One of them is the assets back of the security, and the other the amount of earnings shown in any one year or over any series of years as available for the interest or dividends upon the stock or bond.

It is of course a pleasurable task for the salesman to point to large assets upon which to claim high investment worth. Often, however, the salesman himself scarcely appreciates the necessary distinctions between safety based on assets and safety arising from excellent earning power.

It is quite natural that the average person should assume that a bond having a large amount of property behind it may be accepted as safe. The average investor, and in fact the average seller of bonds, feels a certain sense of security when he sees large amounts of property set out as the basis of a bond. And there is good reason for this attitude of mind. There is something

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tangible about the property that the investor looks to when he makes a rough calculation as to how much he would get for his debt in case the property had to be taken for its satisfaction.

When you buy a mortgage on real estate, the selling value of the property is almost the sole consideration upon which the loan is based. By much the same process of reasoning the investor might decide upon the purchase of a railroad or industrial bond. But upon critical analysis, the analogy between the cases soon disappears. There are certain conditions surrounding a piece of real estate that are entirely absent in the case of an industrial plant and are positively unthinkable in the case of a big railroad system. The investor who buys a real estate mortgage really does, generally, get the specific piece of property just in the way anticipated, in case of default in the payment of interest or principal.

But the case with industrial corporations and railroad systems is different.

It is true that in each instance, and especially in the case of industrial bonds, a large property account is a very desirable foundation upon which to build. However, it must be said that this factor has no great weight in the case of

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railroad systems—although with a public utility corporation, say a power concern, it takes on some significance.

Even where the showing of assets is large there is still some analyzing to be done. The character of the large amounts in the assets column is of vital importance. The average investor, looking at the balance sheet of a corporation, either does not grasp the full import of the figures, or is misled by an imposing array of figures set down as assets. Especially does this apply to the industrial corporation, where such items as patents, good will, etc., are elastic enough to meet the optimistic estimates of the most enthusiastic boards of directors or auditor. This is not to say that these items are of no value, but the element of worth they represent is one that is subject to estimate and judgment, which may vary greatly, depending upon who is responsible for them.

Under such circumstances it is obvious that the amount of assets as footed up in a balance sheet is not altogether the criterion upon which to build one's confidence in the safety of a security. The amount of property that may be shown is a very important factor, not because in and of itself it represents the ultimate security of the bond, but

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because it shows a basis for earning power, given the right conditions.

The point at issue is, however, whether earning power, in its final analysis, is not the ultimate basis of safety for an issue of bonds. The answer that it is has been given in the field of railroad finance years ago. It has long since been known by intelligent investors that to hope to take over an important piece of railroad property in satisfaction of the mortgage upon which default may have occurred it utterly impracticable. There is a sense of security in knowing that your bond has a first or second mortgage on important mileage, but the statement in the mortgage that in case of default the bondholders may enter upon and take possession of the property is well-nigh a legal fiction.

Every intelligent buyer of railroad bonds nowadays knows that the exact designation of his security stands for little else than the relative position it occupies in the general scheme of the line's capitalization, and indicates more the priority of his claim against earnings than the degree to which he may expect to be satisfied by entering upon and possessing the property. In the first place, the increasing unity of the great

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railroad systems of the country makes it almost impossible for one piece to live without the others. There is a homogeneity in the railroad field that could not be broken by the drastic action of any group of security holders. In the second place, what would a group of bondholders do with a large stretch of railroad mileage considered as so much track and buildings? Every one knows that when a railroad defaults its obligations, there is a readjustment of securities and the property is pushed along with the attempt to make it a rejuvenated and going concern.

So well is this understood that bond dealers generally neglect to make any statement of the property value of a railroad when selling its bonds. The balance sheet of a railroad seldom appears in a bond circular. But the statement of earnings is given great prominence.

On the other hand, the balance sheet is given conspicuous attention in the circular offering an industrial issue if the bond be that of a concern in reasonably good standing. Often when there are no particular reasons for emphasizing the earning power of the concern, the assets are made the chief element of display.

What is the situation with respect to the in-

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dustrial issue and its dependence upon earnings? If the property cannot show a sufficient margin of safety for the bonds as a going concern, what may the bondholder hope to get if he were to foreclose on the property for its selling value? He might get the entire amount of his debt, provided the bond issue were not too near the total value of the plant. But if the earning power were not there, the margin between the total amount of bonds and the property upon which they were to be satisfied would have to be wide to insure such a happy outcome.

In other words, the matter is resolved into a question as to what the bondholder would do with the property after he gained possession, if it could not earn enough to maintain the issue of securities. This question has confronted many security holders in the past. When they bought the bonds, there appeared to be a strong, valuable property beneath their loan, upon which they might lean for recovery of their principal in case of default. Business changes and altered industrial conditions, however, dried up the earning power of their company, and they were forced to take a property which, in figures and in the estimate of its management, was amply sufficient

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to pay off all debts, yet which in the stress of conditions could not be sold for enough to meet all claims on it.

The truth of the statement that the ultimate safety of the bondholder lies in the ability of his corporation to earn interest and other charges, finds its greatest substantiation in the case of industrial bonds. Of the host of miscellaneous corporations that come under this head many could not possibly be sold under the hammer to meet all claims, for the very good reason that when industrial trouble comes in its most serious aspects it strikes not one or two, but many concerns. The very reasons which make a company unable to meet its interest or other obligations make it also a difficult property to sell. The result of default is generally a readjustment of securities, with greater or lesser loss to all security holders, and a continuation of the business so that old holders may get a chance to re-coup in future years what they have had to sacrifice in order to forestall even greater losses.—Frederick Lownhaupt.

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CHAPTER VI

Points for the Beginner

THERE is nothing difficult or mysterious about the art of investing money safely and profitably. It is, in essence, nothing in the world but a commonsense proposition, and the mysterious part of it is why many who are sensible and intelligent enough in ordinary business affairs seem to lose their good sense immediately when they start to invest money for an interest return.

The inexperienced investor is apt to fix his eye on two points only:

1. Rate of interest.
2. Safety of principal.

And in many cases he will take big chances as to safety in order to earn an extra one per cent. interest. He would have to get that extra one per cent. for a hundred years before he could afford to lose his principal—and by that time he is likely to be where rates of interest will not worry him.

In the first place do not invest in an enterprise because it is near at hand. This is a most com-

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mon error on the part of those unfamiliar with investments.

It is a common fallacy to think we know all about a local enterprise. We buy stock in a shoe factory in our home town, although the population of the town has not increased for ten years and the tendency of the shoe business is all in favor of the big, centrally located factory. But we are afraid to buy stock in a bank in Seattle or Los Angeles, where the population is increasing rapidly, even though the soundness of the bank is vouched for by the strongest investment houses and the most conservative bond dealers.

Second, do not consider the interest return on the investment from the point of view of your own necessities. Do not reason that you have only $20,000 capital and cannot live on less than $1,400 a year, therefore you must make your money earn seven per cent.

The investment market cares nothing about your personal needs. An investment which pays seven per cent. interest usually does so because well-posted capitalists consider it less safe than others paying six per cent. or five per cent., oth-

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erwise the price would speedily rise until the yield was reduced.

Now it may be that capitalists have not yet discovered the value of this seven per cent. investment and that it pays that rate because it is less generally known than another equally safe investment which yields only five per cent. But while this is possible, it is not probable; and before you decide that the seven per cent. investment is just as safe as the five per cent. investment you must know every detail of the business of the company and everything which may affect the future value or safety of the stock. You must know the property thoroughly, know the character of its officers, its earnings, its competitors, the future prospects of its territory, and in studying these factors you must put out of your mind all thoughts of your own requirements.

Again, as a rule do not value advice highly because the adviser is your friend. If your friend is in a position to know more about the property than any one else and if you are sure that his interests do not blind him to the real facts of the case, well and good—give his advice due weight. But do not buy stock in the South American

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Gold Mining Company because your clergyman thinks highly of it, because it is being promoted by a local lawyer in whom you have confidence, or because Jackson, the well-known Wall Street plunger, tells you on the quiet that Gold Dredging is going to be a second Butte & Boston.

Your adviser may be and doubtless intends to be perfectly honest; but also he may be carried away by his enthusiasm, he may have formed his opinion without sufficient investigation, he may have taken the advice of a friend, or he may be one of those persons whose perfectly honest views always coincide with their own interests (a most convenient temperament and very common).

The most valuable advice is generally that of a disinterested and well qualified person whose business it is to give advice; that of a high-grade bond house, which is always searching for the safest and best-paying investments for its customers; a newspaper or magazine whose subscribers depend upon it for sound and conservative statements; or a capitalist who has no connection with the company under consideration, but who has made a fortune by his sound judgment of values.

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Do not take any advice unless it agrees with your own deliberate judgment. No adviser knows your circumstances and resources as well as you know them and no adviser will devote as much thought and careful study to your investment as he will to his own.

Do not depend upon newspaper statements as to the value or earnings of a property, its future plans or its business prospects. Remember that the reporter who wrote those items would not be writing them if he really had any important knowledge of the subject—he could make more money in other ways. Remember that his principal object is to write something that will interst you and make you buy the paper.

The majority of newspaper financial reporters are truthful so far as the conditions under which they work permit them to find out the truth, but their knowledge of the subjects on which they write is necessarily small and their opportunities for thorough investigation are limited.

Finally, do not be in a hurry about making your purchase. The golden opportunity which must be seized now or forever lost may not look so

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golden after you have obtained all possible information regarding it.

Do not permit yourself to get enthusiastic. In that respect the science of investment differs from every other line of business. It is often said that enthusiasm is the lever that moves the world. That is true in regard to earning money, gaining promotion, perfecting an invention, selling goods, or writing a poem.

It is not true when it comes to investing your hard-earned shekels. That is the time to weigh and consider, to cultivate a healthy cynicism, to hold your imagination in leash, and get down to solid facts. Remember that it is enormously easier to make money than to keep it.

It is a good plan to divide your fund for investment into three parts:

1. A reserve or sinking fund, as it may be called. This should consist of about one-half of the capital you now have on hand. It should be permanently placed, with a view to safety of principal and income, and with the expectation of trenching upon it only in case of disaster to other investments, loss of health, or failure of earning capacity.

Interest return will receive only slight consid-

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eration in the placing of this reserve fund. Safety is the important thing.

What you will do with this part of your money will depend upon your individual circumstances and character. Perhaps you will invest it in a house and lot, reckoning the saving of rent as interest on the investment, selecting a location where you believe real estate values are likely to advance, and getting out of your investment the comfort of an established home in addition to interest return.

Perhaps you will put it into real estate mortgages, or property which you personally know and believe to be well situated. If you cannot conveniently investigate your own mortgages, perhaps you will purchase some of the guaranteed mortgages which have recently become popular in certain sections. You may conclude to put it into the best and highest grade railroad or municipal bonds, selected after consultation with the most conservative bond houses, and yielding only a moderate rate of interest.

If you are a small investor and of a cautious temperament you may even prefer to keep this part of your money in a savings bank. In nearly every case, however, even the small investor can

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find a more profitable way to place his reserve fund than in a savings bank. He can, as a rule, buy what the savings bank buys, thus getting the return on his money that the savings bank would get, and saving that part of the running expenses of the bank which would be charged to him if he deposited his money with it.

2. The other half of your capital may well be employed in investments which return a higher income and which have in addition some speculative possibilities.

It must be borne in mind that investment and speculation cannot be entirely separated. Even if you buy government bonds, you are taking chances on the solvency of the United States Government. This is a very slight chance, of course, but it is still a chance. You are facing a speculative possibility, willy-nilly. If you buy a mortgage, you are taking the risk of a Galveston storm, a San Francisco earthquake or a Baltimore fire. The element of risk can never be entirely eliminated from human affairs.

All your investments, therefore, will be in a sense speculative. You are simply dividing them into less speculative and more speculative. The greater the element of speculation, the greater

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should be your return in interest payments and in increase of value.

This speculative fund, like the reserve fund, will be variously invested by different people. Your tastes may run to real estate, your neighbor's to industrial stocks. If you have little knowledge of business and no opportunity to inform yourself adequately, the second grade of bonds, or the best class of dividend-paying railroad stocks, yielding perhaps five per cent., will afford a good opportunity for the investment of this part of your capital. You will endeavor to buy in a panic. Thereafter, if you wish to take a strictly investment position, you will probably continue to hold your bonds or stocks regardless of price, adding to your holdings from time to time from your surplus fund as explained below.

3. You will of course gradually accumulate a surplus from the interest on your investment and from your earning capacity. If you are like the majority, a considerable part of this surplus will be spent in increased living expenses, luxuries, travel, etc.; but a part of it will doubtless be added to your permanent capital.

You should take special pains to invest this

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accumulating surplus in a readily salable form. Then in case your monthly or yearly surplus suddenly turns to a deficit you will not be obliged to trench upon your regular investment funds. You may prefer to carry this surplus in a trust company, where it will earn a small interest and yet be instantly available.

Some make the mistake of using this surplus for "flyers" in the stock of newly organized companies, "second Bell telephones," etc. Even if such stocks are really of value, the market for them is apt to be uncertain and treacherous. When the surplus turns to a deficit these stocks will be of little value in filling the hole.

As this surplus accumulates it is well to gradually transfer it to your two investment funds, keeping them about equal in amount.—G. C. SELDEN.

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CHAPTER VII

Characteristics of a Good Investment

IT is important to have a clear understanding of the general characteristics of a good investment and the rights of the investor. There are only three kinds of securities:

1. Some sort of promise to pay—a bond, mortgage, note, or loan on collateral.

2. An equity, by which the purchaser becomes the owner of a fractional part of the company—a certain number of *shares*.

3. A security which is convertible from one of the above forms into the other under certain conditions specified on the face of the security itself.

Some stocks are far safer than some bonds; and at certain times and under certain conditions *any* standard dividend-paying stock is better than *any* standard bond.

For example, the stock of the Pennsylvania Railroad, which has paid dividends steadily for fifty years, is a much safer investment than the bonds of a new road which is barely meeting

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fixed charges and might be thrown into the hands of a receiver by a few years of hard times. It is customary to recommend bonds as a woman's investment and for trust funds, etc., but there are bonds and bonds; and there are some stocks which represent enterprises so firmly established that the shares sell on an income basis as low as that of high grade bonds.

Likewise, in a period of generally rising prices for commodities, all lines of business become very prosperous. Profits, as measured in dollars, are large, and all stocks, being equities, or fractional parts of an enterprise, have improved dividend prospects and consequently rise in price. On the other hand, the very activity of business increases the demand for money and this raises the rate for money in the general money market, so that a bond, bearing a fixed rate of interest, does not give as good returns as money otherwise invested. The holders of the bonds sell out and invest their money elsewhere, and the bond, as a result, declines in value.

At such a time any sound investment stock is better to hold than any bond—and this wholly without reference to the amount of security be-

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hind the bond. It is not a question of security, it is a question of the rate for money.

A *mortgage* bond is merely a mortgage split up into convenient units so that it can be more readily sold and transferred. Each bond is a certain fraction of the entire mortgage, just as each share of stock is a fraction in the ownership of the company. The mortgage bond is based upon definite, specified security. This may be a "general lien," covering all the property of the company, and usually subject to some "prior liens"; or the mortgage may cover only a certain part of the company's holdings, specified therein.

A *debenture bond,* on the other hand, is scarcely a bond at all—it is practically a note, collectable from the company just as any note is collectable from an individual.

The interest of an *income bond* is payable out of the company's income. If the company has no income it defaults the interest, but this does not throw the company into the hands of a receiver. In other words the income bond is in much the same position as the stock, except that the dividend on the income bond will not be increased beyond the rate specified in the bond,

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while there is no such limit to possible dividends on the stock.

An *equipment bond* is a lien on certain specified equipment, and is usually paid off in instalments as the equipment depreciates through service.

The *collateral trust bond,* as its name indicates, is secured by specified collateral placed in trust for the benefit of the bondholders.

A *convertible bond* may be converted into stock under certain conditions which are specified on its face—usually at a fixed price and under certain limitations as to date.

Varieties of stock are few in number, as all stock must represent a share in the business. Preferred stock is entitled to full dividends before the common receives any dividends, and if the preferred is cumulative all dividends in arrears on the preferred must be paid before any distribution can be made on the common. If the preferred is non-cumulative, whatever dividends are passed will not be made up in the future, but all additional earnings over the amount to which the preferred is entitled year by year will go to the common.

Before going further a brief discussion of the

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general characteristics of a good investment is necessary.

1. Safety

It is often assumed that funds may be so invested as to assure absolute safety. In fact, there is nothing "absolute" outside of the science of mathematics—everything is comparative. The element of risk is always present, though it may be in very small degree.

"Safety" means different things for dlfferent people. For a widow, left with a small property on which to support and educate her children, safety means an investment which can be left to itself year after year and can be depended upon to yield a certain, definite income. For a business man who is investing his surplus, who is not dependent upon his interest money for his living, who can exercise some judgment as to the business situation and who has the advantage of sound advice on market conditions, the word safety covers a much broader range. He is warranted in taking a "business man's risk."

There is one important element in safety, which is little understood by most investors, and

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yet has a most far-reaching influence—the purchasing power of money.

One might suppose, for example, that nothing could be safer than consols—the consolidated bonds of the British Empire. Yet in recent years they have proved far from safe, if safety is to mean the maintenance of capital as well as an assured interest. Consols had already suffered a severe decline before the Great War began. While England's increasing indebtedness doubtless had its influence on the price of consols, it was generally believed that the great increase in the production of gold was the most important factor. This brought about rising prices and active business, thus tempting a large number of investors to sell their "promises to pay" a certain amount of gold at a specified date, and to invest their money in "equities," where they would get the advantage of the great increase in the value of the property as measured in gold. As consols yielded a very low rate of interest, they were among the first to be disposed of, and such sales naturally had a depressing effect on the price.

The safety of an investment, therefore, cannot

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be judged solely by the amount of security back of it. Safety against a decline in price is equally important.

2. Rate of Interest

All the world knows that, as a rule, the lower the interest yield on the price of a security the safer the investment. This is only saying that investors will be content with a smaller return from an investment which they consider to have the highest degree of safety.

Yet the judgment of the crowd is far from being always right. United States Steel preferred sold at 50 in 1903, although paying 7 per cent. dividends on par and 14 per cent. on the price. Subsequent events have proved that these dividends were not only assured, but that the security behind them was being enormously increased year by year. Seaboard Air Line 1st 4s sold at 92 in 1905; yet the road went into the hands of a receiver and these bonds went down to 43 in 1908—a decline of over 50 per cent. The buyers of these bonds at 92 were very seriously in error.

You may reply that on the *known* facts at the

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time, the Seaboard bonds were worth 92 in 1905, and the Steel preferred was worth only 50 in 1903; but you would have hard work to prove your case.

Investors, like everybody else, labor under what may be called "the delusion of fixed ideas." That is, they fail to examine each individual security on its merits, but roughly apply certain preconceived notions to all securities alike. They know that the security labeled "bond" precedes the security labeled "stock" as a lien on the property; hence the word "bond" adds something to the value. They know that railroad securities are safer than industrial securities as a rule; hence the word "railroad" adds something to the value. They are intensely conservative and prefer old and long established companies; hence the securities of a new company are at a disadvantage, no matter how excellent they may be. And it is precisely this lack of originality and failure to investigate and discriminate on the part of the vast majority, that enables the investor of active mind and sound judgment to realize a large return on his capital.

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3. Salability

Many persons find it necessary to hold only securities which are readily salable on short notice. They must be salable not only in good times but in panics, as the panic is likely to be just the time when the owner might find himself over-extended or involved in outside operations, and might therefore require the use of the funds represented by his securities.

This fact adds to the price of securities having a broad and ready market, beyond the price at which they would naturally sell as a result of safety of capital and rate of interest. For this reason the investor who can be certain of his ability to hold securities until a favorable market can be obtained, may often pick out a better bargain by selecting a security which is little known and has a narrow market.

For the reserve fund previously referred to, salability is of little importance provided the value is there. Inactivity is no bar in considering purchases to go into this fund. It may be an advantage and it may not. Some securities are inactive because they are scarce and closely held. They may even be higher in proportion to their

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value than other securities having a broader market. But there is another class of stocks and bonds which are inactive because little known, or because no special effort has been made to bring them to the attention of investors. Such securities are likely to return a relatively higher rate of interest in proportion to their value and soundness.

Some years ago Sears, Roebuck & Company preferred stock was a good example of a little-known security returning a large interest rate and amply secured. The company was doing an enormous business, was rapidly extending its field of operations, and had a "good will" asset the value of which it would be impossible to estimate. Yet little was heard of the stock and it was selling relatively low. More recently Mr. Sears sold his interest in the company to New York capitalists and the stock was brought into public notice with a corresponding advance in prices.

For your speculative fund inactive securities will not do. The first essential for that fund is a ready market. The first of a series of "golden rules," used by a well known capitalist in his market operations, is said to be: "Never specu-

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late in an inactive security." And even though the primary purpose of your speculative fund is to yield a good rate of interest, you cannot afford to include in it anything that cannot be sold promptly if desired.

4. Speculative Possibilities

On neither your reserve fund nor your speculative fund can you afford to neglect speculative possibilities. No matter what security you buy, you are certain of one thing—if there is any public market for it, it is going to fluctuate. All its fluctuations mean profit or loss to you; therefore you must consider them. This applies to government bonds and Steel common, though not in the same degree.

When we talk about speculation in connection with investments we do not mean "taking chances." It has been said that the rich can afford to take chances but do not, while the poor cannot afford to take chances, but do. One of the main purposes of this series of articles is to aid persons of moderate income in avoiding the taking of dangerous chances.—G. S. Selden.

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CHAPTER VIII

Selection of Securities

THE average investor will wish to put part of his reserve into bonds and part into stocks. There may be exceptional cases in which it is better to put the entire amount into bonds, as the principal is then certain to be returned at the maturity of the bonds if the company remains solvent; but the highest grade stocks always involve less risk than some bonds.

We must discriminate carefully between (1) long term bonds bearing a fixed rate of interest, (2) short term bonds, such as equipment or car trusts, and (3) convertible bonds, which may be exchanged for stock having speculative possibilities.

Long term bonds are, in nearly all cases, intended by the company issuing them to continue as permanent outstanding obligations. In some instances their date of maturity is 100 or even 200 years ahead. They may, therefore, sell a good deal above or below par.

For example, when the current interest rate on capital invested in bonds is, say, 4 per cent.,

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a 5 per cent. bond maturing in 100 years will sell at 124.52, or almost 25 per cent. above its par value. On the other hand, a 4 per cent. bond running 100 years, will sell, in a 5 per cent. market, at 80.14.

That is, the investor who buys a $1,000 5 per cent. bond for $1,245.20 will receive $50 a year interest on it, but when it matures 100 years later his descendants will get only $1,000 for what cost him $1,245.20. And if he pays $801.40 for a $1,000 4 per cent. bond running 100 years, he will receive $40 a year interest and at maturity the bond will be paid at $198.60 more than it originally cost him.

Hence long term bonds fluctuate with the money market. In 1902 an average of high grade bonds stood at a price of over 108, but in 1907 the same bonds averaged about 88. The 20 point drop was due to a change in the condition of the market for money and capital. If a bond was yielding 4 per cent. on par during that time, the fall in the market value of the principal was equal to the entire amount of the interest for the five years.

It is important, therefore, to invest in long term bonds only when they are selling on a rea-

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sonably low price basis. At other times funds may more profitably be invested in short term securities, or in stocks if the outlook for stocks is favorable.

Short term bonds, or notes, as they are often called, cannot fluctuate widely in price as a result of money market changes, since they are soon to be paid off at par value.

Car trusts or equipment bonds are very desirable securities, but apparently are not thoroughly understood by the public. It is stated that there has never been a default on an equipment bond. The reason of this is easily understood when the character of the bond is considered.

The equipment bond results from the purchase by a railway company of locomotives, cars or other equipment on the instalment plan. Suppose, for example, the road needs $5,000,000 worth of new equipment. The railway company pays $500.000 down and issues equipment bonds for $4,500,000, of which $500,000 is payable each year during a period of nine years. The company usually obligates itself to keep all such equipments in good repair and to replace such as may be worn out or damaged during the ten years.

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Now, a railway cannot run without equipment. Hence no matter what happens to the road, this equipment will stay there. Even if the road goes into the hands of a receiver, that does not affect the claim of the holder of equipment bonds, as his security is in the equipment and not in the road itself.

Not only this, but each year, as one-ninth of the bonds fall due and are paid, the security behind the remaining bonds becomes proportionately greater.

Owing to the fact that such bonds are for a short term, and because of the exceptional nature of the security behind them, also because they usually return a good rate of interest, they are especially desirable.

The convertible bond is a bond so long as the holder wishes it to remain a bond, but under conditions specified in the bond itself, it can be exchanged for stock if desired.

If the convertible clause in the bond has no money value, then the bond has the same value as any non-convertible bond of the same class; but if the stock into which the bond is convertible rises above the price fixed for the conversion, it is evident that the price of the bond will

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follow it. Hence the convertible bond participates in the speculative possibilities of the stock. These may be nothing at all or they may be very important.

For those who know nothing of finance, bonds which are legal for the investment of savings bank and trust funds in New York and New England are probably the best. The requirements of law in regard to savings bank investments have been summarized as follows:

"The standard is practically the same under both laws, except that New York requires that the corporation must comply each year for five years, whereas Massachusetts requires ten consecutive years. This test is that the railroad corporation shall own in fee at least 500 miles of standard gauge railroad; that its gross earnings each year, including the gross earnings of its leased lines and the gross earnings from the sale of coal from mines owned or controlled, shall be at least five times the interest on its entire indebtedness and the rental of all leased lines operated by it, and also that such corporation shall have paid to its stockholders each year an amount at least equal to four per cent. upon its outstanding capital stock, and that such out-

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standing capital stock shall be an amount equal to at least one-third of its entire indebtedness."

Considerably less than one-quarter of the funded debts of American railways is composed of these "legal" bonds, and many bonds which do not meet these requirements are just as strong as those which do. Nevertheless, all bonds which meet this legal test are pretty sure to be good bonds. Hence the usefulness of the law for those who do not care to investigate for themselves, or who distrust their own judgment. The circulars of bond houses announcing new issues usually inform the investors in what states the bonds are legal for savings bank and trust funds.

Good *municipal bonds* generally yield so low a return on the investment that they are not attractive to investors who attempt to manage their funds shrewdly. Occasionally, however, an offering of municipal bonds goes at a low price because the municipality is distant and little known, even though the security may be unquestioned. The following are the principal tests of a municipal bond:

1. Is the city or district an active and growing one?

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2. Is the value of property relatively large in proportion to population? That is, is the community a wealthy one?

3. Is the tax rate low?

4. Is outstanding indebtedness small?

5. Is the bond vouched for by a banking house of high standing?

Irrigation bonds vary greatly in character and each issue must be examined on its individual merits. In some cases they are backed by municipalities and are considered securities of the best class. In other cases they are issued by private corporations and partake of the nature of industrial bonds. Some personal knowledge of the section to be irrigated, the water supply, and the general character of the enterprise is extremely desirable before investing in such bonds. The endorsement of a responsible bond house which has made a thorough investigation would in any case be essential.

Industrial bonds were at first regarded with some skepticism by the majority of investors, but the strength of many issues has now become generally recognized. A liberal interest return may often be obtained from such bonds if the security behind them is ample and unques-

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tioned. On the whole, however, they must be regarded as a "business man's risk."

Various companies have offered bonds or guaranteed mortgages based on real estate security, divided into convenient units of $100, $500 or $1,000 each, and paying 4½ per cent. to 6 per cent. Before purchasing such securities, it is necessary to investigate:

1. The character of the real estate upon which they are based.

2. The character and standing of the company issuing or guaranteeing them.

Guaranteed mortgages paying 4½ per cent. to 5 per cent. occupy a different position. If the guaranteeing company is sound, such mortgages offer the very best security and may well be considered carefully by those desiring the safest form of investment.—G. C. Selden.

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CHAPTER IX

How to Analyze Railroad Earnings

IN the first place, the investor should bear in mind the two important classes of securities:

First, those which are so abundantly secured that no question will ever arise as to their soundness, no matter whether business conditions are good or bad. If the earnings applicable to pay the interest on a railroad bond have been, over a period of years, four times as much as the amount required to meet that interest, the bond may be considered as above all fluctuations in earnings and further investigation in regard to the character of the property may be waived. The price of such a bond would depend almost entirely on the money market, and the money rate is the important thing to consider in deciding whether or not the bond should be purchased.

Second, securities on which the earnings applicable have proved, over a series of years, less than four times the requirements. Such stocks or bonds will be affected by the earning power

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of the road to a greater or less degree according as the surplus above interest requirements is less or greater.

It is natural for investors to look at the present earnings of a road as the measure of the value of its securities. Experience shows, however, that earnings will fluctuate from year to year to such an extent that it is not safe to base conclusions on a single year. An average for five or ten years is needed in order to even up the minor changes in earnings which depend upon the fluctuations of activity in general business.

The study of a ten years' average in this manner will often enable the investor to pick up good bargains. In a time of dull business and restricted earnings the prices of railroad securities will be affected by such conditions more than is warranted when a broader view of the situation is taken. Under these conditions it is always possible to select roads which are certain to recover their large earning power when business improves. A ten-year average will quickly indicate such securities, in the absence of any special conditions injurious to the particular issue under consideration.

All earnings should, for purposes of study, be

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reduced to a mileage basis; that is, earnings for the year should be divided by the average mileage operated during that year, in order to arrive at a fair basis of comparison with other years or with other roads.

The only test of the value of a security (aside from the condition of the money market) is the earning capacity of the road as affecting the particular stock or bond under investigation.

Take, for example, Norfolk & Western Ry. first consolidated 4's. You figure as follows:

10-year average net income per mile, N. & W. Ry.	$5,398
Interest requirements per mile for five issues of bonds having a prior lien, total	555
Average income per mile available for first consolidated 4's	$4,843
First consolidated 4s outstanding per mile being $24,150, interest required per mile is	840
Balance above requirements	$4,003

That is, the interest requirement was earned nearly six times.

As the Norfolk & Western is a well maintained, economically operated road, in a growing territory, these first consolidated 4's are evidently, from the above figures, above and beyond the influence of fluctuations in earnings.

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In making a more detailed study of earning capacity, the different factors are found to group themselves under three general heads:

(1) *General.* What is the character of the territory in which the road operates? Are population and wealth increasing? What is the proportion of manufacturing and general business to agriculture, and is that proportion increasing? Is public sentiment in that territory favorable to railroads, or hostile to them? Is the foreign commerce of that section increasing?

Also, is the management of the road composed of practical railroad men or is it speculative? Is the road managed on the field, or is it managed from Wall Street?

(2) *Operating Conditions.* Are the roadway and equipment being properly maintained and improved in comparison with previous years and with other roads similarly situated?

What is the character of the traffic hauled—coal and iron ore, lumber, agricultural products or miscellaneous freight? Of course the miscellaneous freight and manufactured articles pay the highest rates and should normally show some increase in proportion to other traffic.

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Freight density and passenger density are to be considered. By freight density is meant the freight tonnage multiplied by the number of miles said tonnage is hauled, and divided by the total mileage of the road. Likewise passenger density means the total passengers multiplied by the miles carried, and divided by the mileage of the road. These figures are useful for yearly comparison and for comparison with other roads.

The average train-load, train-mile earnings and average rates should also be studied in comparison with previous years and with other roads. A small change in the train-load or in train-mile earnings will make a big change in the total of net earnings at the end of the year.

(3) *Statistics of Income.* These are easily obtainable from current statistical manuals. Net earnings, other income, fixed charges, and excess of earnings over dividends are the most important points to be noted.

The following condensed statement of the principal points to be considered in reading a railroad report may be of interest:

Compare year by year:

Income Account.

1. Gross earnings per mile operated.

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2. Per cent. of operating expenses to gross earnings; affected by:
   (a) Rates.
   (b) Class of freight hauled.
   (c) Character of equipment.
   (d) Condition of road-bed.
   (e) Empty car mileage.
3. Per cent. of cost of maintenance to operating expenses.
4. Ratio of net earnings to fixed charges.

Balance Sheet—Note changes in:

1. Funded debt.
2. Floating debt. (Is it balanced by current assets?)
3. Capital stock.
4. Compare changes in rentals with changes in income of rented lines.

Physical Condition and Management.

1. Freight density (= ton-miles ÷ mileage operated.)
2. Passenger density (= passenger-miles ÷ mileage operated.)
3. Train-loads (= ton miles ÷ freight-train mileage, or passenger-miles ÷ passenger-train mileage.)
4. Locomotive-miles yearly.

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5. Tonnage per car yearly.
6. Proportion of local to through business.
7. Mileage of foreign cars.

The best and most convenient sources of information are the annual pamphlet reports of the various roads the various statistical services which compile the figures in a convenient form for a series of years, the yearly manuals and the monthly pocket manuals which compile current earnings.— G. C. Selden.

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CHAPTER X

Some Facts Study of Railroad Balance Sheet Reveals

IT is comparatively simple to understand the various items that go to make up a balance sheet, especially when they are arranged after the most approved fashion. With railroads a certain fashion has been set through the standard laid down by the Interstate Commerce Commission, which gives the railroads a prescribed form to follow in presenting their figures. This form is practically the one that is presented to the stockholders in the annual report.

Taken alone, the balance sheet of a railroad for any one year does not disclose nearly so much information as when the figures of that year are put in comparison with those of the year previous or with those of a series of years.

A glance at the balance sheet of a railroad is not sufficient to disclose the value of the exhibit. There must be some study and probably some further analysis of items that are directly related to those in the balance sheet or items which are summarized very briefly.

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The great majority of investors look immediately to the income account of a corporation for the clue as to the strength or value of a security; and in a large sense they are correct in assuming that this is the principal index to the safety of their investment. But even this statement is subject to some modification when the railroad bond is under consideration.

This modification also applies when there is a lack of harmony between the condition of the income account and the showing of the balance sheet in respect to the current position of the road.

In explanation of this it may be said that it has happened that a road was showing good current earnings, although at the same time its current position as shown by the balance sheet was in anything but a favorable condition. Under such circumstances one would likely be misled by depending upon the indications given by a study of the current earnings alone. There are usually several months of each year when any road has improving income, and if this were the situation just after the line had had several months of depression, it could easily be imagined that a

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strong brace in income would give a special brightness to that side of the picture.

The moral from this is to analyze the current position of the road. It is upon the current liabilities the structure may break. That is to say, in studying the balance sheet of a road, see first whether the cash position is strong or weak with respect to the excess of current assets over current liabilities. The immediate cause of many troubles in the railroad world is the anemic condition of the property. It is in a poor cash position and therefore may not be able to stand the test when called upon to do new financing to get money for refunding obligations that have become due, or to prosecute works of improvement.

It will thus be seen that there is a vital relationship between the cash position of a railroad and the stability of its securities. This relationship lies in the strength or weakness that is imparted by the balance sheet showing. Suppose a company has a weak current position and must do some financing very shortly. It is evident that the road will have to pay heavily for its funds; or, if it is so weak that it cannot accomplish satisfactory financing, or can do none ex-

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cept at ruinous cost, it is evident that the near fate of that property is the receiver's hands. It will not be altogether sufficient that this road show two or four months or even six months of good earnings for in this there would be no guarantee that the pace could be maintained.

The proper study of the balance sheet, therefore, involves a consideration of this vital relationship between the current position of the company and the requirements of the company in the immediate future. If the company shows a weak cash position and in the near future must do some financing, it is evident that the condition of the money market at that time will be a determining factor in the situation.

When considering the cash position of a company it is of particular interest to note just what the treasury assets are that are available for sale to procure funds for meeting maturing obligations or for other requirements. This is a factor of vital importance. The critical student of the balance sheet of the railroad makes a careful analysis of the securities available either for outright sale, such as bonds that have been authorized and issued but are available in the treasury

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for sale, or securities that are available for hypothecation in loans.

Just how all this affects the investor who already holds securities of the company may be seen from the fact that there is a direct relation between the cash position of the company and its credit position. And its credit position is the determining factor in the situation when maturing obligations are to be met or new financing accomplished. The value of a comparison of statements over a series of years becomes plainly evident when it is considered that a company must show a sustained favorable cash position accompanied with a sustained and favorable showing in earnings, if it is to enjoy sustained and favorable credit.

It will be understood from what has been said already that the cash position is shown in the working or current assets. Many investors labor under the mistaken idea that the profit and loss surplus has something vital to do with the cash position of the company. Often an investor is heard to remark on the size of the profit and loss surplus shown in the balance sheet, which, if very large, conveys the impression to him that

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the company is an infinite distance away from difficulty.

It cannot be repeated too often that the surplus in the balance sheet of a railroad, or in fact of any other corporation, is nothing more than the balancing entry to make two sides of the balance sheet coincide. The surplus does not mean that the company is better off in cash than is actually shown in the working or current assets. Generally speaking, a very large proportion of the profit and loss surplus is represented by various items scattered over the asset side of the sheet a large part of which may be wrapped up in the property account; that is, tied up in assets that could not possibly be liquidated in a moment of urgent need for ready money. Of course, if a considerable part of this surplus is wrapped up in treasury securities—that is securities which may be readily sold—so much the better, for under these circumstances the cash position is the stronger.

There is still a third consideration, somewhat of a bookkeeping matter, but nevertheless interesting to the student of the position of a company as disclosed by the balance sheet. It is in the so-called deferred debit items. They are put

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on the asset side of the sheet, but they are designated as deferred with good reason. The average investor looking over the balance sheet is not at all clear just what these items mean.

In the railroad sheet nearly all of them represent money that has been advanced to subsidiaries and which the lending or parent company expects to get back some day. Now the lending or advancing is done for two general purposes: For meeting current needs, as, for instance, interest money on the subsidiary company's bonds, if that company cannot earn enough of itself; or for building or developing the subsidiary company's property. If the money is advanced for the latter purpose, the lending company expects some day to get the money back by funding the same; that is by issuing securities to cover the transaction. If the advances were made for interest money or other current expenses, the parent company just has to wait for the return of its money. There are many cases where the wait will be very long.

There is a certain railroad system which has a subsidiary that last year had a deficit close to a million dollars. The advances each year for several years have been close to this figure. With

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the parent company not too prosperous, it will be a long cry before these advances, which can be ill spared, come back. A little study of these features of a balance sheet is always profitable.
—FREDERICK LOWNHAUPT.

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CHAPTER XI

Book Values Are No Final Basis for Judgment

ONE of the pitfalls into which the average investor is certain to fall is the trusting acceptance of the stated book value of a security as the basis for judgment of that particular security. He is to be excused somewhat for this, however, if he stumbles, because he does not know just what the term "book value" means. The average investor is thoroughly ignorant of the method and means whereby the book value of a security is arrived at. This phrase, like many another similar one, is something having reference to the accounting side of the question, and it is natural that it is not to be fully understood except by those familiar with bookkeeping.

It will, therefore, be proper to explain just what is meant when the phrase book value is used. It will then be seen why the investor should not be content with the stated book value when considering the security offered.

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It is upon the figures contained in the balance sheet that the book value is determined.

The term book value has more reference to the stocks of a corporation than to the funded debt. Usually the funded debt has for its security some tangible form of property, such as the railroad line itself or the manufacturing buildings of an industrial corporation. It is, therefore, not so much a question of determining the book value of a bond as it is the book value of a stock.

It could, of course, be said that there is such a thing as book value to a bond because there is generally back of the bond some definite property and this property is carried on the books of the company at a certain valuation. Therefore, if a corporation has outstanding ten millions of first mortgage bonds which have as their security a first lien on the entire property of the company and the entire property of the corporation is valued at two millions in excess of the outstanding amount of bonds, it is evident that there is an apparent margin of safety in the value of the property. This, in substance, is the situation with respect to the bonds of a corporation, although it should be remembered there are numerous variations.

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In considering the security back of bonds it is not usual to make any reference to book value. There is supposed to be sufficient property pledged under mortgage bonds to take care of them in case the security holders should ever find it necessary to take over their property to satisfy their claim.

When bonds are offered for investment, it is usual to lay emphasis on the value of the property pledged for their safety and also to emphasize the value of the equity which seems to exist over and above the total of the bonds outstanding. That is to say, it is frequently stated that the bonds have a certain amount of property pledged, say 125 per cent. of their total par value, and have back of them an equity of a certain amount, which usually is figured out by taking the market values of the securities following the bonds. If the bonds under consideration are senior securities and there are preferred and common stocks, it will be seen that the equities will generally work out at comfortable figures.

In the case of railroad and public utility securities this matter of equity may be emphasized with reason in pressing the securities for sale, although in the case of industrial securities it is

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applicable also in a large degree. In the same manner there is an equity created for a preferred stock where there is outstanding common stock.

Now it is evident at a glance that this equity is highly fluctuating if the securities which figure in it are moving up and down in price constantly. Whatever weight is given to this matter of the equity should only be given after a thorough consideration of the market position of the securities which go to make up the equity. Take, for instance, some of the newer industrial securities that have come out over the past two years. When they were issued they were quoted around par in many instances. In the past few months the market prices have depreciated enormously, so that the equities of some of them have been cut down to low figures.

Judging the value of a bond, however, by taking into consideration the actual property pledged for its safety and then as a further consideration the total market value of the stocks or other securities following those particular bonds is something entirely different from the matter of book value.

The book value is generally worked out by taking the total assets of the corporation as

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shown by the balance sheet, subtracting from that total the liens against those assets and then dividing the remainder by the amount of stock outstanding. That is to say, all the quick liabilities are subtracted from the total assets, along with the other liabilities such as bonds or notes not considered as current or quick liabilities. The remainder is the amount as representing the total book value of the outstanding stock. Of course, if there are preferred stocks these must be subtracted at par from the remainder and then the second remainder gives the figures for the book value of the common stock.

From the method in which the book value of a security is derived it is evident that the book value cannot be accepted as the final basis of value. It changes frequently and often in a manner that the investor does not become aware of until some time later. The change in the quotation of the stock in the open market may not be great over a moderate period of time, yet the change in the book value of the security may be considerable.

Yet again the change in the book value of the stock may remain almost stationary and the quotation may go slumping down many points over a

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short period of time. There is one security that might be mentioned that showed a few months ago a book value of around 120. A current balance sheet would still show it nearly as high. Yet that stock has gone down to a quarter of the book value in a few months.

The investor must ask about these things if he would not make serious mistakes in choosing his securities. He must look into the factors that give book value to a security. There are some industrial companies without any bonded or funded debt that might show handsome figures for book value, yet a very large part of that book value is derived from the liberal figures which the property is put at in the balance sheet. That is to say, the company may have no bonded debt, so that when the current liabilities are subtracted from the total assets there remains a substantial sum, and it would look as if the stock had a large value. Yet the company's working capital may be small because current liabilities may nearly offset current assets and leave little except the property against which it would be necessary to figure the book value of the stock.

It is evident that this is a precarious asset against which to figure the value of the stock.

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The figure may show up good, yet the company may have insufficient working capital and may be even hard pressed for funds. It may be unable to carry on its business as it should and may be even showing very poor earnings. Yet in spite of all this the book value of the stock may snow in high figures.

In brief this is the situation that the investor must consider, for it touches him in two ways. One of these is when he buys the securities themselves which are rated at a high book value and is led to believe that there is something particularly good about this fine statement of book value. The other is when he buys securities which are secured by collateral, part or all of which consists of stocks which are rated at a high book value.

The writer calls to mind the case of certain notes of a railroad which were secured by a miscellaneous lot of collateral, the bulk of which were stocks. The book value of the stocks made the collateral look as though there were $150 securities for every $100 of notes to strengthen the obligation, which was already the direct obligation of a large railroad. Yet the notes sold at a large discount a short time before maturity.

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The investment public had discerned the true value of the notes and had not paid much attention to the rosy estimates of the value of the collateral back of them.

The book value of a security may be an excellent and useful factor in selling, but as a final appraisement it is often useless and actually misleading. A critical analysis of the factors that go to make up book value is a safer course.—FREDERICK LOWNHAUPT.

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CHAPTER XII

Industrial Bonds and Guaranteed Stocks

THE bonds of manufacturing, mercantile and similar companies constitute a class by themselves. The average investor has a prejudice against them, as they are comparatively new in the field, and the "conservative" class fears everything new. For this reason the discriminating buyer may by careful investigation be able to pick up bargains in this field.

Industrial bond issues are usually small in proportion to the company's capital stock, and in many cases do not exceed the actual value of real estate and natural resources owned. In such a case the bond is not far different from a real estate mortgage, and has behind it as additional security the value of the company's other property and of the business as a growing concern. Such a bond is sound and may sometimes be purchased at a price to yield a relatively large interest return. Of course it is not always safe to trust the company's book valuation of real es-

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tate, mines, water powers, etc. Actual values should be ascertained.

If the issue of bonds exceeds the value of the company's real estate and natural resources owned outright, it is then based in part on the earning capacity of the business, and net earnings must be studied before the bonds can be passed upon.

If possible, net earnings should be examined over a period of about ten years so that good times and bad many be included. If earnings are available only during a period of active business, then the nature of the company's product must be carefully considered and allowance made for the conditions that may arise during dullness in trade.

If earnings are subject to violent fluctuations, or if the price of the product is variable or the demand for it uncertain, it is not, as a rule, wise to purchase bonds which are based in any degree upon prospective earnings. But if the company's product is a staple and if its earnings show no greater fluctuations than the proportionate changes in the total bank clearings of the United States, for example, then a bond based

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in part upon such earnings may be a safe and desirable investment.

The fixed charges of an industrial company should of course be much smaller in proportion to earnings than those of a railroad company, and the term of an industrial bond should ordinarily be shorter than that of a railroad bond, for the reason that the business of most industrial companies is more subject to possibilities of changes in methods, new inventions, etc. It is also generally held that an issue of industrial bonds should not exceed the actual value of real estate and natural resources, plus the net quick assets of the company. That is, if for any reason the company should close up its accounts and sell all its property, the amount realized should be sufficient to insure the payment of the bonds.

Most industrial bonds are subject to wider fluctuations than railroad issues, and should therefore be purchased soon after a panic, or in a period of dullness and low prices. Very inactive issues should be avoided, because the investor may wish to dispose of them in "boom" times, which in the nature of the case cannot be expected to continue indefinitely, with a view to repurchasing at a lower price.

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Second grade industrial bonds, or those which do not meet the requirements set forth above, should be avoided. They are a sort of hybrid, neither a sound investment nor a good speculation.

Guaranteed stocks form a security much like a bond, but having certain advantages over the ordinary railroad bond. Most of the big railway systems have been built up by consolidation of smaller lines, and in this process the controlling systems have frequently guaranteed the dividends of the roads thus absorbed. For instance, the Pennsylvania Railroad Company leases the United New Jersey Railroad & Canal Company for 999 years, agreeing to pay all operating expenses and interest charges, taxes, organization expenses, and ten per cent. annual dividends on its stock. This road is the main line of the Pennsylvania Railroad between Jersey City and Trenton and provides its terminal in the former city. Similarly, the Pennsylvania Company leases the Pittsburg, Ft. Wayne & Chicago Railroad Company, which is the main line of the Pennsylvania System from Pittsburg to Chicago; the New York Central & Hudson River Railroad Company leases the Rome, Watertown & Og-

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densburg Railroad Company, and so on.

The dividends on guaranteed stocks are prior obligations to those on the stock of the guaranteeing company. Joseph Walker & Sons, in a booklet on the subject issued several years ago, estimated the value of the securities of some of the large corporations, to which their guaranteed stocks are prior obligations, as follows:

Pennsylvania	$600,000,000
New York Central	285,000,000
Illinois Central	160,000,000
Reading Company	160,000,000
Del., Lack. & Western	160,000,000
Lake Shore & Mich. So	150,000,000
Delaware & Hudson	75,000,000
Western Union Tel	75,000,000

In many cases, the leased roads have no bonded debt, their stocks being their only obligation.

Stocks guaranteed by leading railway systems have the following advantages:

1. Security of principal and certainty of dividends practically equal to the best railroad bonds.
2. No maturity dates, which simplifies matters and prevents the necessity of reinvestment at a fixed date, when the markets may not be in a favorable condition.

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3. Small denominations, par being $50 or $100, permitting small investments; and absence of coupons, thus eliminating the possibility of loss by theft or accident, which exists with coupon bonds.

4. Exemption from all taxation in a number of states, where bonds would, of course, be taxable. As taxes are now 1 to 2 per cent. in most localities, this exemption from taxation is equivalent to an increase of that amount in interest return.

The laws exempting guaranteed stocks from taxation are much the same in Maine, Massachusetts, Rhode Island, Connecticut, New York, New Jersey, Pennsylvania, Ohio and Michigan. The idea is, of course, to prevent double taxation. The New York law reads:

"The owner or holder of stock in an incorporated company, liable to taxation on its capital, shall not be taxed as an individual for such stock."—G. C. Selden.

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CHAPTER XIII

Industrial Preferred Stocks

MANY of the industrial preferred stocks have reached the point where they may properly be termed safe and conservative investments for business men. American Beet Sugar preferred, American Cotton Oil preferred, United States Steel preferred, etc., have a record of steady dividends behind them, and the earnings of these companies are usually sufficient to pay the preferred dividends several times over. Yet in years of low prices some of these preferred stocks have sold at prices to yield 8 or 9 per cent., and even in times of high prices they would have enabled the investor to realize 6 per cent. on his money.

It would naturally be supposed that the reason these stocks sell at relatively lower prices than the preferred railroad stocks is the doubt in the minds of the investors about the stability of earnings, as the profits of industrial companies necessarily fluctuate more widely than those of railways. The best industrials, however, have now passed through several periods of business

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depression and have always "bobbed up serenely" within a year or two.

Moreover, it is a curious fact, and one not generally appreciated by investors, that industrial preferred stocks did not suffer much worse during the panic of 1907, for example, than railroad preferred stocks. To bring out this point, I have compared the extent of the depression of prices in 1907, as compared with the high point of 1906, for 16 leading industrial preferred stocks and 10 railway preferred stocks. For the 16 industrials the average difference between the high price of 1906 and the low price of 1907 was 33.9 per cent., while the 10 preferred rails declined very nearly as much, or 30.9 per cent. This is in spite of the fact that the "margin of safety" for the rails is, on the basis of last reports, 50 per cent. greater than the margin of safety for these industrials. Two industrials, Cotton Oil preferred and United States Steel preferred, showed a smaller relative decline than any of the ten preferred rails. Similar conditions have been noticeable during the depressed investment markets of more recent years, but I select peace conditions for the comparison.

This serves to emphasize the point that the

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margin of safety is not as good an index of the stability of an industrial as it is of a railroad stock, because of the sudden changes in industrial earnings which frequently take place. Yet this does not fully explain why the industrial preferred stocks were as stable as the railway preferred stocks in the 1907 panic. It seems to have been the case that the holders of industrials, while insisting on a higher interest return than the holders of the rails, nevertheless had equal confidence in their securities and held them on the decline with equal tenacity. This plainly indicates that the industrial preferred stocks are coming to be more and more a factor in the conservative investment market.

There are some curious anomalies in investment markets. Why did Northwestern preferred sell on a 3 per cent. basis in the tight money markets of 1906? It is equally difficult to say why Panhandle preferred, in 1907, fell to a basis of 7.1 per cent. on the investment. Both prices were ridiculous, and show that there is just as much opportunity to make money by discrimination in the purchase and sale of stocks for investment as there is in speculation pure and simple. Republic Iron & Steel yielding 14 per cent.

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on the investment, and Rubber 1st preferred at 13 per cent. in 1907 were equally absurd. Such prices could only be due to the pressing necessities of large holders.

In the proportion of earnings applied to improvements there is considerable difference in the various industrial companies. Moreover, it is difficult to draw an accurate comparison between companies because of the different methods followed in making up income accounts, and especially in charging off depreciation and cost of improvements, additions and betterments. In some cases these items are charged against operation, in others against surplus after dividends, and in others against profits and loss surplus.

Don't forget that it is just as important to buy at the right time as it is to buy the right stock, especially in the case of securities which are subject to considerable fluctuations.

When you have made up your mind on a stock you would like to own, take your time about making the purchase. Remember that we have big declines as often as once in three years on the average, and that is pays you, as a rule, to wait three years in order to buy your stock even 10 or 15 points cheaper. When a panic comes,

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don't lose your courage because prices are low—that is the best possible reason for having courage. The biggest fortunes in this country have been built up by being a bull on the United States—having confidence in the future and in the destiny of our industries at times when less courageous investors dared not buy. It's a great country and neither the plutocrats nor the anarchists are big enough to smash it.—G. C. Selden.

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CHAPTER XIV

How to Judge Bond Values

BEFORE we can intelligently consider what a railroad bond is, and how to judge its value, we should have clearly in mind the fundamental difference between bonds and stocks.

A railroad bond is a promise to pay; a stock represents an equity. The distinction between bonds and stocks is, therefore, the difference between a promise to pay and an equity. Railroad bonds, real estate mortgages and loans on collateral represent somebody's promise to pay a certain sum of money at a future date. If the promise be good and the security ample, the holder of the promise should be paid the money when it is due.

Stocks, on the other hand, represent only a beneficiary interest—a residuary share—in the assets and profits of a working concern, after the payment of its obligations and fixed charges. The value of that residuary share may be large or small; it may increase or diminish; but in no case can the holder of such a share require anyone to

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redeem this share at the price he paid for it, or at any price. If a man buys a railroad bond of $1,000, par value, he knows that the road, if solvent, will pay him one thousand dollars in cash when the bond matures. But if he buys a share of railroad stock, his only chance of getting his money back lies in someone else wanting to buy his share.

Another point: If he buys a bond he becomes a creditor of the company. He has no voice in its management; but he is entitled to receive his principal and interest when due under the trust deed mortgage which the company makes to the trustee. On the other hand, if he buys a share of railroad stock he exercises his proportionate share in the management of the company; he shares ratably in its profits and in its losses.

A railroad bond is an obligation of a railroad company, usually secured (but not always), by a mortgage on railroad property. The bond runs for a certain length of time at a certain rate of interest.

Now it is evident that there are two accidental considerations which affect the price of that bond, as distinct from its intrinsic value; these are: First, the length of time which the bond has

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to run; Second, the rate of interest that it bears. It is evident, for instance, that a five per cent. fifty-year bond, based on a certain security, will sell at a very different price from that of a three and one-half per cent. twenty-five-year bond based on the same security, yet the only difference is in the accidental conditions which are under the control of the board of directors, when they make the bond.

Bond dealers in order to eliminate these accidental features from the situation, have adopted a very simple device. To the bond dealer it does not make any difference how long a bond runs or how much interest it bears. He considers only the net yield of the bond, or, as bond dealers say, the basis.

If a bond sells above par, it is evident that it does not yield as much as its coupon rate; that is, if you pay 110 for a six per cent. bond, it will not yield you six per cent., for two reasons. First, because there is ten per cent. loss in premium—you pay $1,100 for a $1,000 bond, so you lose $100 of your principal. Another reason is, the six per cent. which the railroad pays is only on the par value of the bond—the coupons would be $30 each, two payments a year, or $60. For

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these two reasons a bond which sells above par does not yield as much as the coupon rate of the bond.

In the same way, a bond that sells below par yields *more* than the coupon rate. If you buy a bond at 92 you are getting more than six per cent. on $1,000. You also get eight points ($80), in excess of the value of your principal before the bond becomes due.

These "yields" that I speak of have been calculated with the utmost exactness. They are published for bonds running from six months to one hundred years at from two to seven per cent. It is only necessary to turn to these tables to find the net yield on a given bond at a given price. The net yield is usually spoken of as the "basis," and many bonds are bought in the Street almost invariably on a "basis" price.

The general principle is this: The value of any obligation, I do not care what kind of an obligation—any promise to pay—depends on the margin of security in excess of the amount of the loan. That principle is very simple in the case of real estate mortgages. If a man comes to you and says: "I have a mortgage of $20,000 which I want to sell you," your first question is,

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"What is the appraised value of the property?" If he tells you that the mortgage is secured on property worth $50,000, and he can prove it satisfactorily to you, the mortgage of $20,000 looks like a pretty safe investment.

In the case of a railroad property, these three things are to be considered, (1) the rate per mile, (2) the amount of prior lien bonds, and (3) the amount of junior lien bonds.

When I say the rate per mile, keep in mind that principle I have alluded to, that the value of any obligation depends on the margin of security in excess of the amount of the loan. In the case of a railroad bond, the only way to figure is on a per mile basis. If a person should offer you a six per cent. bond you would ask how large the issue is. If he says, "Three Million'" he is not telling you anything, for you do not know what the value of that property is in excess of the three million that has been put into the railroad. You must ascertain from the mortgage how many miles of road this covers, then divide the total amount of the loan by the number of miles; this will give you the rate per mile.

The first question that occurs to you is—How heavily is the road bonded? Say a road is down

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south somewhere—take the road that runs from Birmingham to Atlanta. You ask, "How much did the road cost?" The answer is, it is bonded for $25,000 per mile.

You say, "I do not want any of these lines; the Atlantic Coast Line, which is a very profitable property, is only bonded for $20,000 per mile. If they can build a road at $20,000 per mile, I do not believe I want the other bonds. I would rather have the Atlantic Coast Line's."

Suppose I offer you a $20,000 mortgage on real estate worth $75,000, and on which there is already a first mortgage of $25,000 (that would make $45,000), you would consider it a pretty good loan, but, of course, you can see that your mortgage is not as good as the other prior mortgage for $25,000—the man who holds the first mortgage has the best proposition. It is the same with railroad bonds. A railroad will sometimes put three, four, five or six issues of bonds on the same line. It makes a vast difference whether you are "next to the rails or next to the stock." Take the Erie, for example, a road running out of New York to Chicago. There are seven mortgages on that road. The first mortgage issued by the Erie Co. is called the Prior

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Lien, but it is actually the sixth mortgage. The reason why they are called the Prior Liens is because when the Erie was reorganized it changed its name, and this issue of first prior lien bonds was made by the new company. There are six mortgages before that one. If you did not know this, you might think you were getting a good thing in the Prior Lien bonds.

The second point I wished to bring out is, that the amount of prior lien bonds on the same mortgage is a matter of the utmost importance. You must know how many there are, because they work against the security of your bond. Conversely, the amount of junior liens—the amount of bonds which follow the bonds that you have —works directly in favor of your bonds.

I was talking with a very successful bond buyer of one of the large insurance companies a while ago, about the International & Great Northern Railroad, which went into the hands of a receiver.

I said, "Mr. So-and-So, haven't you some of those bonds?"

"Yes," he replied.

"Losing any sleep over it?"

"No, not a bit," he answered.

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"Why, how is that? I thought you had the Thirds."

"No," he said, "I have the Seconds."

He was not losing sleep because the third mortgage bondholders, in order to protect their interests, would have to "buy him in." He would get par for his bonds. It makes a great difference to bondholders whether there is anybody else behind them in a foreclosure.

There are, therefore, three things which concern the value of the property of railroads: the rate per mile at which the bond is issued, the amount of prior lien bonds on the same mortgage, and the amount of junior lien bonds. Those three considerations tell you the probable safety of your principal.

When it comes to the safety of the interest there are three more considerations: Earnings per mile, Net Income per mile, and Fixed Charges.

The gross earnings of a road are very important. Of course, that carries with it the whole question of the territory the road is in, the diversity and the density of its traffic. You also have to consider the possibility of an increase in its traffic. Take a road which runs out west—a

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granger road, as the Atchison was several years ago. It made all the difference in the world to the Atchison whether they had a good corn crop in Kansas or not. If good, the road made money; if poor, it lost money. If you have a road like the Pennsylvania, or the New York Central, which act as regular funnels (nearly all of the traffic of the country goes through these two systems), you will find that they have a tremendous diversity and density of traffic. Roads lying in the same territory have somewhat the same conditions to face.

The net earnings of a road are found by subtracting from gross earnings its operating expenses, and sometimes its taxes. Frequently taxes are reported as expenses; sometimes they are reported as fixed charges. In order to compare two roads you must see that your taxes are put in the same place.

The net earnings of a road are very important, because they carry a criticism of operating expenses. There is no point in railroad financing even when a road intends to be perfectly honest, that is so hard to decide, as whether a certain item should be charged to operating expenses or to capital. With the very best inten-

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tions in the world a board of directors often cannot tell.

We will say that a road has a wooden bridge over a certain river. It originally paid so much for the bridge, and charged it to capital, of course. There comes a time when the bridge is worn out, when it will not carry the heavy train-loads, and they are obliged to have a steel bridge. They pull down the wooden bridge and put up a steel one. This costs $75,000. The old wooden one "stood them in" $20,000. They do not earn one dollar more for having the steel bridge instead of the wooden bridge. The question is, How much of that $75,000 should be charged to capital and how much to operating expenses?

The average operating expenses are about 66 2-3 per cent. on steam railroads; less on tractions. If you find a road that is operating for 60 per cent. it would indicate that the cost of conducting transportation is very small. It might mean that they carry big train-loads. It might indicate that the physical condition of the property is being neglected. It may mean, as in the case of the wooden bridge, that nothing is being charged to operating expenses and all to capital. It might mean that they have not made

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any repairs, such as replacement of ties, steel rails, etc. It may be that new capital has been issued and you have nothing to show for it. It is very important to find out which it is if you can. You cannot always tell from the report of a road; it then becomes necessary to find these things out indirectly.

I had a case the other day of a road in Florida. Looking over the property, I found that they had 450 miles of single track road, and that their expenses for maintenance of way were $670,-000. I immediately said, "Here, what are you doing?" He replied, "We padded that because we did not want to show the earnings." The management had heard that the Commission was coming after them, and feared they were making so much money the Commission would make them reduce rates. If I had found that the 75 per cent. they were showing in their operating expenses was due to inefficiency in management, or to any crookedness in the handling of traffic, I would not have touched the stuff.

The payments of the road have to be analyzed to show what they are doing with their figures. After a while you learn by experience how much it ought to take to maintain a road. One thou-

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sand dollars per mile for maintenance of a single track road is high maintenance; $750 to $850 per mile is good maintenance for a single track road, and about half as much more for each additional track. If you find a road that is running its maintenance up to $1,500 per mile, you know that they are padding their maintenance.

Fixed charges include interest on the bonds and on current liabilities, also taxes, if the taxes are not reported in operating expenses. Taking the fixed charges and comparing them with net income, there should be a good margin over and above. Of course, the same thing applies in the underlying bonds; the interest required may be earned ten times over, and their position is strengthened correspondingly.

Sometimes a road will own stocks in another road, and get a little indirect income from them. Net *income* means net earnings plus any other income the road may have. Net *earnings* are the gross earnings less operating expenses. Any other income beyond that figure gives what is called net *income* and that is the net revenue of the road—that is what you have to consider. The average road is earning a little more than twice its interest charges. To put a bond in the

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first investment class it should earn anywhere from two or three times its interest charge.—GEORGE GARR HENRY.

NOTE.—This and the following chapter were revised from lectures at the Finance Forum.

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CHAPTER XV

When to Buy Bonds

A MAN may be unsuccessful in investing money because he may buy bonds at the wrong time. Nobody can be successful in this line unless he is able to judge whether conditions are favorable for the purchase of bonds or not. Of course, certain institutions, like the life insurance companies, have a great deal of money to invest every year. Money rolls in to them. They invest it. There is no use in their selecting times when bonds are low and holding them to sell out when high. Their income comes in and they place it to the best advantage by taking the best thing that is offered at the time. With most individuals it is very easy not to buy now, but to wait two or three or four years, if necessary—to select the right time.

I want to show you that all market movements of negotiable securities—and this applies equally to stocks as to bonds—are subject to the control of two influences. One of these is the *Loaning*

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Rate of Free Capital; the other is the *General Condition of Business.*

Of these two factors the Loaning Rate is usually more important, so far as certain grades of securities are concerned; and the General Condition of Business is much more important so far as other grades are concerned. You take a choice municipal bond, the City of Boston 4 per cent. bonds for instance; it doesn't make any difference what the condition of business is in their case. The interest on the bonds of the City of Boston will be paid just as surely in bad as in good times. They will collect the taxes all right. In times like these, interest rates are very low, and it is natural that people who have money to invest buy bonds which are high grade, such as the City of Boston bonds. After a while conditions will change; interest rates will be high. At a time when they are high it stands to reason that the fellow who has that kind of stuff sells it in order not to be loaning the money too cheaply. There always tends to be an adjustment between the two. At a time when interest rates are low, all bonds tend to advance to a point where their yield is greater than the yield from

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loaning money. When interest rates are high, bonds tend to go down. That is axiomatic.

The other factor—general business—is equally true in its effect. A man who buys Great Northern at 350, as some people did, does not consider whether it is a good purchase as far as the money rate goes. The stock only pays 7 per cent. Why did he buy it? Because he saw what the general condition of business was. Their earnings were so high that it was only a question of time when they would have to declare a great extra dividend or scrip dividend. He thought he would get a melon of some kind. Under those conditions you go in and buy a stock at a price where the loaning rate of money would not influence you at all. Take to-day: Stocks like Reading are selling at, and yielding very little over 3 per cent. Nobody is buying them as an investment proposition—I mean to get the 3 per cent. They are buying it because of the prospects. They are looking forward to the time when they will sell at 200 or 300. If they thought the company would not mine any more coal than last year, they would not be buying the stock to-day.

Second and third mortgage bonds and stocks

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of this sort are influenced almost entirely by the general condition of business. The investor says, Business is good, so I will buy some of these "pups." I will make a little on them. On the other hand if business is poor, the investor will say, I will buy stuff like City of Boston 4s. He does it simply as a business operation.

These two factors sometimes act together; when they do the effect is irresistible. We are in exactly that kind of a time now.* Interest rates are low. We cannot loan money. We pay two per cent. to banks on money which we cannot loan out. We have had an election which has pleased most of us, so far as business goes. We think things are going to be good, business better, money rates low. Both of these influences are operating to advance things. All classes of securities for the last two or three months have been going up. Usually that is not so; usually these two forces work against each other—the better business is the higher money is. Tight money has the effect of reducing the prices of securities, and good business conditions have the effect of advancing them. Between the two the inter-connection is usually economic. It

*Dec. 2, 1908.

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has the effect of imparting a very weak appearance to investment bonds; it gives such a weak appearance to security markets that everybody thinks prices are being subject to manipulation and speculative influences.

In a general way the movements of all securities are affected by these two influences; you can see it just as well as if you were studying the law of gravitation. Let us take a case where interest rates are very high, and the prospect of business condition is very good—at least where everybody thinks the prospect of business is good. We will say we are back in 1906, or 1907. Money rates were very high. You could not get money. If people wanted to borrow money they had to pay fancy rates for it. Mr. H. H. Rogers, supposed to be worth an enormous amount of money, came to make a loan on his property. He had to pay a high rate for the money. Everything was O. K., his road was absolutely sound, but he could not get any money except by paying very fancy rates for it. Business conditions looked very good; everybody was making money; totals were bigger than ever before.

What was the effect on security prices? All high grade stuff was going down—Baltimore &

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Ohio Prior Lien 3½s, Lake Shore First Mortgage 3½s, New York Central 3½s, Pennsylvania Consols—all stuff which did not yield much. People said they could not afford to hold such securities. Middle grade stuff, often yielding 3 per cent., was going down. Why? Because you could get 6 per cent. for money. Stocks like Reading were selling at 160. It was a very curious looking market, yet it was perfectly natural. The high grade stuff was going down to a point where it was yielding just as much money, and the second class stuff was going up to a point where people thought they were discounting the future. That is a condition favorable to the decrease of high grade stuff and the advance of poor stuff.

Take a time when interest rates are low and business bad. What would be the effect? High grade stuff would go up. Some bond dealers said, "I hope Bryan will be elected." Why? "Because," they said, "we will have 'bum' business and higher prices for bonds." It would have had that effect, too. High grade stuff would have gone up.

Supposing you had, in prospect, poor business conditions, money easy, high grade stuff going

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up, middle grade stuff going up. People would be a little afraid of them. Supposing earnings were getting poor. People would say, I had better slip the low grade and get into high grade stuff. The tendency of money would advance the latter. What would be the effect on the other stuff?—third and fourth mortgage bonds—something that is not so good? You would say, "I cannot hold them, I am afraid of them. I will slip them and buy high grade bonds. I want something safe." That is the effect.

Up to this point I have only shown that market movements of securities are subject to two influneces. I want to show that these two influences can always be counted upon to act with perfect regularity, and in a perfectly normal way throughout the course of a credit cycle. In every civilized country, business conditions undergo alternate periods of prosperity and depression; these changes are in cycles of substantially the same length. Of course, we say that the recent panic came a little ahead of time. There was a good reason for it. A little spirited talk about capital rebate, rake-off, etc., had the effect of making capital timid. To the extent that it made capital timid, it was as if the supply of capital had been lessened. The very fact that it came

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a little sooner than expected indicates that we will get over it quickly, and it will have been a good thing. On the other hand, certain things retard a crisis. If a country puts out an abundance of paper money, it has the effect of putting off the approach of a crisis, because it creates more capital. This is a bad thing, because such an increase is entirely artificial, and it only makes the day of reckoning more severe.

We have a big panic every twenty years, and a half-way panic every ten years, or substantially so. You can tell beforehand how the prices of bonds will be affected. Right after a panic money becomes very easy. The amount of money required throughout the country for operating money, till money, counter money, pocket money, and all that sort of thing, is enormous. So long as the volume of business goes down so much money is not needed. Money then flows in to the big financial centres, like New York, Chicago, and St. Louis, and piles up there.

This is not capital, it is money. Do not make any mistake about that. It has no effect in stimulating a renewal of business, because in a sense it only represents people's liquidation of their investments.

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This goes on for a year or two years. Gradually things look better. Times improve. The change may come quicker or slower. Mines will open, new railways will be built, manufacturers will put up new plants here and there, factories will be started, and similar kinds of vast enterprises, all calling for money. The laborer has a little more to do. This goes on until gradually interest rates rise and rise. Just before the panic interest rates get very high, and money cannot be borrowed at any price. Optimistic men do not see the warning. They try to borrow money from abroad and from the Government through the national banks. If people will not buy securities they are asked to make loans. This expansion continues until some trifling incident—like last year—some unimportant thing starts the ball rolling. Banks say, "I wonder whether So and So is good; I guess I will call his loan in." Then the whole thing comes down like a house of cards.

You can trace through these periods the probable course of any grade of bond you may select. Right after a panic money gets easy. High grade bonds then are low, because under the influences of high money they have been going

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down. After a panic people buy high grade stuff. That grade of bonds rises and rises to a point, somewhere towards the middle of the cycle, where it is on a parity with money rates. Money rates then necessarily go up, and people say, "I won't buy any more high grade stuff now; I am afraid it is going to drop." For awhile momentum will carry it along. As long as high grade bonds go to a point where money is worth a little more than bonds, it follows from that there is no more profit left in buying bonds. As long as you can get 4½ to 5 per cent. for six months' money you do not want to buy any more of those bonds. They will go down until the next panic.

Take the third grade bond; it comes out of a panic at a pretty low price, because it is seen that they are going to have trouble ahead. People will say that such bonds are pretty low; they may even go along for a whole year and not rise a bit. Business conditions are bad and the chances are that the road will not be able to earn money enough to pay interest on its bonds. Then, if money is 3 per cent., they will say, "I will not buy that bond."

If a bond pays a larger percentage—lots of

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them do—they are even then afraid to buy it, for if it should go into the hands of a receiver it would not be worth 30.

The recent panic (1907) has been a quick one; the "pups" have already risen in price. These "pups" of a road are next to the stocks, the very last to rise in price, and when you find them doing so within a year, it is sure that conditions will become better. Bonds like that will go on advancing until just before the next panic. People who handle bonds downtown will say now that the "juice" is almost out of high grade stuff; they will now deal in second and third grade bonds, for, as money goes up, high grade stuff will go lower.—GEORGE GARR HENRY.

Note—The above lecture was delivered in December, 1908. High-grade bonds reached their highest prices in February, 1909, and thereafter declined continuously until August, 1910, showing the correctness of the principles laid down.

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CHAPTER XVI

Legitimate Mining Investments

THE investor has himself largely to blame for the number of mining companies that are organized simply for the purpose of selling stock. He is too often ready to take a chance because, forsooth, Mr. Smith has invested in stock at 5 cents a share and has sold it at $5 or possibly $10 a share. He is, therefore, willing to risk a few hundred or a few thousand dollars on what he believes to be such a chance. The promoter has given him information regarding neighboring properties, and shows the possibility of an investment in his stock. Without investigating at all, the money is invested. If ordinary care were exercised in making these mining investments there would be more successes in developing prospects into mines and fewer losses through investments in prospect stocks.

Mining is certainly a legitimate and profitable business. We may look at the records of some of the wealthiest men in the country and we find that they have made fortunes through small legitimate investments. The mines themselves have

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turned out millions of dollars every year in the way of dividends. There is no mine made in a day, and no mine is developed without the spending of a great deal of money, and without taking a great deal of time. Years of time and millions of money are required to develop a mine like the Calumet and Hecla, the Utah Consolidated and the Centennial-Eureka of Utah, and many other such properties. These were not long ago mere prospects and some of them were pronounced as failures before the development of the wealth found now within their territories. The Utah Consolidated was worked as a gold mine. A large mill was built and later torn down because the mine and mill were a failure. However, in developing the property still further, one of the big copper mines of the State of Utah was found. This has already paid in dividends in less than eight years $7,992,000.

When the Centennial-Eureka was being developed, two poor men were spending all the money they could get, seemingly without promise of success. One of them was cautioned by a friend not to keep putting his money into that hole in the ground. He replied to his friend, "Mr. P., we are not spending your money."

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These men kept on borrowing and working until they had taken out more than $2,000,000 in dividends, and they sold the property for $2,000,000 or more. It is estimated by competent engineers that within this territory there is now blocked out ore worth $100,000,000. There were some, however, who invested money in the stock of this company at $5 a share who would have been glad to have sold out later at $1 a share because they felt that it would be a failure. Those who held on were successful and made a fortune. The above are only a few instances of the vicissitudes in the development of prospects, yet they may be taken as general examples.

There are several things which must be considered. One of these is that the property should be well located in a district with good indications of ore. Another is that the management should be capable and honest. The management may be capable but dishonest, or it may be honest and yet from lack of experience, incapable.

The promoter comes in often as the means of securing funds for developing such a prospect. There is always a chance, of course, for a mistake, and therefore for a loss. It cannot be true that more money is invested in mining than is

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taken out, but it may be true that not more than one or two of such investments prove successes. However, some of these which have failed, or seem to have failed, have been taken hold of again and have been made a great success. There are many such instances in the various districts of Utah.

There is one consideration which has been lost sight of by the investor. Ordinarily those who are in the east, or far from the mining sections, wait until the property has been yielding dividends for some time and then make their investments. Such investments are too often disastrous. There are many such instances. One bought Silver King at $80 a share because it was paying 66 2-3 cents a share per month in dividends. This was good interest on $80. The investor, while he was getting good interest, saw that his principal was dwindling away and the stock declined every year more than the dividends amounted to. The investor, however, might not have lost all this if, as he saw the stock decline, he had sold. The second buyer also sold and so the loss was distributed. The one who paid $80 a share bought it of a party who secured it at only $2.50 a share and sold it after he had

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received $40 a share in dividends. Here was a return of $120 on an investment of $2.50. Those who bought Dady West at $50 a share because it was paying big dividends saw their principal wasting away.

What, then, is the lesson that we can draw from these illustrations? It is a better way to buy the stock when the company is in its prospect stage, and before it begins the payment of dividends. It is wise always to sell, if possible, when the stock is at its height, if one can judge this point.

If I were to make any recommendations on mining investments I would say, buy the stock when it is low and sell when you can double the money, or at least sell enough of the stock to free original capital for reinvestment. By following this course one would never lose in mining investments.

It takes capital to develop a mine. It is legitimate to ask the many to subscribe a few dollars to help in such work. The promoter offers, therefore, an opportunity which could not otherwise be made. But the purchaser, or the one who proposes to invest, should use ordinary business judgment and make his selections with wisdom.

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If this course were followed there would be fewer wildcats set free in the country, and there would be fewer complaints about promoters and mining investments.—WM. H. TIBBALS.

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CHAPTER XVII

Mistakes of Investors

THE most successful investor, or, we might also add, business man, is the one who, through observation, study and self-applied experience, learns to avoid the greater percentage of mistakes.

By the term investor is not particularly meant the person who buys bonds for the small but certain income they afford; in this class should be included every person, whose motive is the realization of earnings upon idle surplus capital; who places his money in any producing or interest-bearing proposition, whether it be bonds or stocks dealt in upon the exchanges, industrial or other shares sold upon the curb, or real estate or other securities purchased at private sale.

The mistakes of investors are multiform in character, but the space allowed for this article prevents mention of but a few only. In a broad sense, then, the mistakes of investors may be grouped under two general classifications, viz.:

1. THE EXCUSABLE MISTAKES.
2. THE WILFUL MISTAKES.

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Under both general classes we might name three sub-classes, viz.:

(1) MISTAKES IN INVESTIGATION.

(2) MISTAKES IN SELECTION.

(3) MISTAKES IN BASIS OF VALUE.

Under the first class, "Excusable Mistakes," may also be classed ,a) those mistakes of judgment, where investigation has been pursued, but where, perhaps, the basis of reasoning has been wrong; or (b) those which follow unforeseen and unexpected events. In such cases it might, perhaps, be more properly termed Misfortune.

Under the second class, "Wilful Mistakes," which probably covers 90 per cent. of the mistakes of the investor, he practically plays the rôle of a blind man asking alms, but at the same time being led by an unprincipled guide, who relies upon the helpless condition of the unfortunate to extract the real pennies from the box and replace them with metal chips which retain the jingle but not the value.

Such investors do not rely upon their judgment; they rarely reason at all on the subject. They are guided solely by excitement, enthusiasm and blind faith. They have in mind one thought only, viz: "Marvelous profits." They

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have dimmed reason with the screen of unreasonable greed.

"Excusable Mistakes" requires no advice or suggestion to enable the investor to avoid them, for he has taken all the precaution beforehand to be expected of a prudent and careful business man. He has investigated; has carefully considered the question of selection, and has analyzed the basis of value. If his reasoning has been wrong, or if unforeseen events bring disaster, it is a misfortune.

Not so, however, with "Wilful Mistakes." The victim to this form of mistake needs advice, counsel and suggestions. He plunges headlong into the whirlpool of enthusiasm, but being weighted down with credulity, sinks and becomes strangled before he reaches the placid cove of promises.

Volumes of advice have been written for this class of investors, and yet "Wilful Mistakes" multiply and grow more numerous from year to year.

Can there be devised and published a formula which will cure "Wilful Mistakes" of investors? If one were to consult the financial pages of the Sunday newspapers, he would at once say Yes!

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The "Information Bureaus," the "Financial Seers," etc., advertised every week at enormous expense, seem to indicate that investors are hungry for advice and are willing to pay for it. These investment advisors proclaim that through a process of "crystal gazing," "feats of necromancy," "inside information," or otherwise, they can foretell the future course of financial events so that no one need go wrong on investments. *Mistakes continue.*

In the prescription of a formula for investors, the real conservative and honest financial doctor would perhaps use as the first ingredient, "Avoid inside or astral information," for it usually comes from those who are not even *in, on the outside.*

The second would perhaps be: Never make an investment on enthusiasm or excitement.

Third: Use your own judgment rather than the seller's enthusiasm in determining the value and merits of the proposition.

Fourth: If you have not the time or facilities for determining the essential points upon which you can base your judgment, get that information even if you have to pay for it. Your own legal advisor is generally a very safe source.

A very prominent financial writer, who has

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a wide and technical knowledge of the basic principles underlying investments, was recently asked if a great many people did not consult him in regard to the safety and soundness of the underlying principles of many investments. His reply was: "No! the public as a rule prefer to lose $1,000 for experience, rather than pay $2 for advice." *Take advice, but not tips.*

Fifth: A common mistake of investors is in not properly discriminating between "market value" and "earning value." The ultra-conservative investor, and the agitator of sentiment against Wall Street, will say, that to buy a stock to-day with the expectation of selling it to-morrow or next week or month at a profit, is not an investment but is a gambling transaction. Such a statement would certainly come under the head of "Wilful Mistakes." The man who buys real estate, most frequently looks to the enhancement of value more than to the earnings for his real profits.

Wall Street is the greatest investment mart in the world; and at times furnishes the greatest bargain counter for investors. The discriminating, careful investor uses his reason and determines when a stock is being sacrificed at a price far below its earning value. There is a reason

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for it, and that reason is a shortage of investors. He knows from past observation and experience that it is only a question of time when Wall Street will overflow with new investors and then prices will again resume the normal "market value." *Learn to look forward as well as backward.*

Sixth: Another mistake of investors is "loss of confidence." It has been proven over and over again that the greatest single source of losses in substantial securities is loss of confidence. The investors hears rumors of impending disaster, which if he would reflect upon seriously for a moment, he would see were impossible, or, if not, could have no real effect upon his security; yet through fear and excitement he loses confidence and sacrifices his securities. This applies also to bank runs (for the depositor in a bank is an investor) ninety-nine out of a hundred of which have been shown to be senseless.

Loss of confidence is a "Wilful Mistake," and the investor can always avoid it by establishing through investigation and reason at the outset—a faith founded upon reason; a faith which cannot be shaken. If a thing is worthy of investment it will usually stand against rumor. Earn-

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ing power, either through advance in market value or through interest returns, should disprove any rumor.

Seventh: Another "Wilful Mistake" is "investing upon names." The financial or political prominence of the men composing the board of directors should not suspend or influence your judgment. They do not promise to put their hands into their pockets to pay you dividends; you must look entirely to the real and inherent merits of the proposition itself for your returns. No high-sounding titles can make it a success if it lacks the true qualities of success itself. Look, therefore, carefully into the real merits first and then ascertain whether it is probable that the men in command of the enterprise will competently, economically and honestly administer your property. *Be watchful of the "has beens."*

Eight: Still one more "Wilful Mistake" of investors, and more particularly those who invest in mining and industrial shares, is "too much confidence"—the placing of too much faith and reliance in what they read. Advertisements and prospectuses which set forth the proposition, frequently contain such alluring statements as will set aflame the latent enthusiasm of a chronic pes-

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simist; yet upon analysis, these statements are simply ridiculous and laughable to one familiar with that particular industry. Therefore, analyze carefully all statements of business in sight, prospective earnings, insignificant expenses, etc. And if you observe too much red paint in the literature make up your mind that there is a "cullu'd pussen" in the background. In such a case it is safer to discard it entirely.

With all the mistakes that could be conceived one of the greatest that any investor can make is that of "pessimism and doubt." Never let your mind fall into that chasm. Do not think because you have lost money in one investment that all are unsafe. Turn back and make a diagnosis of the symptoms which produced the fever of greed, in some particular case, and you will discover in your own mind the safest antidotes.—JOHN J. CUSHING.

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